No. 90-530

In The

Supreme Court of the United States

October Term, 1990

ROUND TABLE PIZZA, INC., ET AL.,

Petitioners,

v.

WILLIAM R. LARSON,

Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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September 24, 1990

QUESTION PRESENTED

Where, following an independent review of the record, a Court of Appeals reverses a District Court on a factual ground not argued by any of the litigants, and in doing so makes an obvious and dispositive oversight which it refuses to correct on a Petition for Rehearing, will the Supreme Court exercise its supervisory jurisdiction under Supreme Court Rule 10 to correct a "far depart[ure] from the accepted and usual course of judicial proceedings ...."

LIST OF PARTIES AND RULE 29.1 LIST

The parties to the proceedings below were the petitioners Richard A. Dumke, Scott O. Bergern, Norman E. Dean, Frederick L. Doar, Paul J. Miller, Robert C. Scheidemann, Charles A. McPhee, Jr., Anne W. Barron, George P. Kailis, Round Table Pizza, Inc., a California corporation, Hills Brothers Coffee, Inc., a Delaware corporation, and Aussies Enterprises, Inc., dba Bonza Tucker, a California corporation, and the respondent William R. Larson.

Petitioners Round Table Pizza, Inc., Hills Brothers Coffee, Inc. and Aussies Enterprises, Inc., dba Bonza Tucker have no parent companies, subsidiaries or affiliates to list pursuant to Rule 29.1.

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OPINIONS BELOW

The opinion for the Court of Appeals for the Ninth Circuit is reported at 900 F.2d 1363, and is reprinted in Appendix I.

The memorandum decision and order of the United States District Court for the Northern District of California (Jensen, D.J.) has not been reported. It is reprinted in Appendix II.

JURISDICTION

Invoking federal jurisdiction under Section 10-b of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)); Rule 10b-5 (17 C.F.R. § 240.10b-5); Section 12(2) and 17(a) of the Securities Act of 1933 (15 U.S.C. § 77l and § 77q); and Civil RICO (18 U.S.C. §§ 1961 *et seq.)*, respondent William R. Larson brought this suit in the Northern District of California. On March 22, 1988, the Northern District, Hon. Lowell Jensen, ruled that Larson did not adequately represent the similarly situated

shareholders as required by Federal Rule of Civil Procedure 23.1 ("Rule 23.1") and therefore dismissed Larson's derivative claims. (Appendix II.) Larson's motion for reconsideration was denied on September 8, 1988. (Appendix III.)

On April 9, 1990, the Ninth Circuit Court of Appeals entered a judgment and opinion reversing the Northern District's order and directing that Larson's derivative claims be reinstated. *See* p. 17, *infra*. A petition for rehearing and rehearing *en banc* was timely filed on April 24, 1990. The Ninth Circuit filed an order denying petitioners' requests for a rehearing and a rehearing *en banc* on June 25, 1990.

The jurisdiction of this Court to review the judgment of the Ninth Circuit is invoked under 28 U.S.C. § 1254(1).

STATUTE INVOLVED

The principal statute involved is Federal Rule of Civil Procedure 23.1, which provides in pertinent part:

> Rule 23.1.
> Derivative Actions by
> Shareholders
>
> . . . The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. . . .

Rule 23.1 is reprinted in Appendix V.

STATEMENT OF THE CASE

A. Factual Background of the Round Table ESOP

Petitioner Round Table is a franchisor of restaurants, most notably pizza restaurants.[1/] Respondent William R. Larson founded and owned 100% of Round Table's predecessor ("Original RTPI"),

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1/ CR 149 at ¶¶29, 62.

until 1979.[2/] By that time, Original RTPI had a franchise base of 148 restaurant units.[3/] On January 16, 1979, Larson exchanged his 100% interest in Original RTPI for (1) a 25% interest in Round Table, (2) a $5,370,000 purchase price supplied by defendants Dumke, Miller, Doar, Dean and Scheidemann (the alleged "Dumke group"), and (3) a $500,000 subordinated debenture of Round Table.[4/] The $5,870,000 total price which Larson received for selling 75% of the company equated to a total company valuation of $7,826,666.

During the nine years of the "Dumke group's" majority ownership and management, Round Table's franchise base almost tripled, to 428 restaurants,[5/] and

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2/ CR 149 at ¶22.

3/ CR 102 at 20.

4/ CR 105 at ¶ 21 and Exh. T.

5/ CR 105 at ¶22 and Exh. U.

the company was valued in the marketplace[6/] and appraised[7/] at $30 million.[8/] Because Round Table was a closely held company, however, its shares were not liquid. It was therefore difficult for Round Table shareholders to capitalize on the appreciation in the value of their company. In 1985 Round Table was also very concerned about attracting, retaining, and providing incentives for the company's employees in the highly competitive food franchising industry. The answer to both problems was found in the Round Table Employee Stock Ownership Plan ("ESOP").

6/ *See* $30 million acquisition proposal by Little Caesar International, Inc. CR 105 at ¶11 and Exh. H. *See also* acquisition proposal by Terrence A. Collins and Robert L. Larive valued at $36,472,000. CR 105 at ¶¶24 and 25 and Exh. V and W.

7/ CR 105 at ¶10 and Exh. G.

8/ At Round Table's appraised value of $30 million, the interest which Larson retained (which now represents 23.41% of the presently outstanding shares) is worth $7,023,000, almost as much as the entire company was worth when he sold 75% of it nine years earlier.

Congress enacted the law establishing employee stock ownership plans as part of ERISA in 1974. *See* 29 U.S.C. § 1107(d)(6); 26 U.S.C. § 401(a). The enactment was reflective of a Congressional determination that it was in the public and corporate interest for employees to have an ownership stake in the businesses for which they worked. *Id.* Substantial tax incentives were granted by ERISA to promote the creation of ESOPs.[2/]

[2/] Four tax rules are of particular importance to a company in Round Table's position contemplating establishing an ESOP:

1) If the shareholders sell at least 30% of the company's outstanding shares to an ESOP, they may roll the proceeds into "qualified replacement" securities issued by unrelated corporations and defer recognition of a gain until the replacement securities are sold (Internal Revenue Code, 26 U.S.C. § 1042);

2) An employer may make tax deductible contributions to an ESOP of up to 25% of the employees' compensation to be used to repay principal on a loan which finances the purchase of the company's shares (Internal Revenue Code, 26 U.S.C. § 404(a)(9)(A));

(continued...)

At the Round Table Board of Directors meeting on April 3, 1985, Mr. Dumke advised the Board of Directors that consideration was being given to the establishment of an ESOP and informational material was distributed.[10/] At the next Board meeting, June 28, 1985, a presentation was made by a representative of the plan administrator.[11/] Following questions, a resolution to establish the ESOP was unanimously adopted. *Id.* Both of Larson's hand-

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2/(...continued)

3) An employer may make additional tax deductible contributions to an ESOP to pay interest on a loan used to finance the purchase of the company's shares (Internal, 26 U.S.C. Revenue Code § 404(a)(9)(B));

4) Beginning in October, 1986, the company may also pay tax deductible dividends on the stock owned by the ESOP if used to make payments on a loan which finances the purchase of the company's shares (Internal Revenue Code, 26 U.S.C. § 404(k)).

10/ CR 105, Exhibit A.

11/ CR 105, Exhibit B.

picked representatives on the board voted for the ESOP. *Id.*

On November 19, 1985 the plan Disclosure Statement was sent to all shareholders, including Larson.[12/] In that Disclosure Statement a price of $9.78 per share was set for the purchase of Round Table shares by the ESOP.[13/] That price was predicated on a $30 million appraisal for the entire company by California Capital,[14/] which in turn was supported by an unsolicited $30 million offer to purchase Round Table by Little Caesar International, Inc.[15/]

The purchase was to be funded by a $6 million loan from Wells Fargo Bank to the ESOP and by the

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12/ CR 105 at ¶ 8 and Exh. E.

13/ CR 105 at ¶ 9 and Exh. F at 6.

14/ CR 105, Exh. G.

15/ CR 105, Exh. H.

selling shareholders (including Larson if he elected to participate) taking back notes from the ESOP for the majority of the balance of the purchase price.[16/] Round Table would pay the interest on the ESOP's indebtedness, and the ESOP's principal repayments were to be funded by Round Table contributing 25% of the employees' gross wages to the ESOP. *Id.* When Internal Revenue Code §404(k) was liberalized in October, 1986, Round Table was also authorized to pay dividends on the stock held by the ESOP for use by the ESOP in repaying the loan from Wells Fargo. All of Round Table's payments to the ESOP were tax deductible.[17/]

Thus, the ESOP was designed to benefit everyone: the company (through improved employee incentives, morale and turnover), the employees

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16/ CR 105, Exh. F.

17/ 26 U.S.C. §404(a)(9)(A) and (B), §404(k).

(through vested stock ownership in Round Table funded entirely by Round Table), and the stockholders (through providing liquidity to their investment on a tax advantaged basis). Management strongly recommended to all shareholders that they ". . . accept the Purchase Offer to the maximum extent possible:"

> The Company's Board of Directors and management recommend that the shareholders . . . accept the Purchase Offer to the maximum extent possible. . . . The Company's executive officers have indicated that they intend to accept the Purchase Offer to the maximum extent possible.[18/]

By the date of closing in December, 1985, all of the shareholders had tendered all of their shares to the ESOP except for Larson, who tendered none.[19/] Larson was willing to sell his shares in Round Table, but not at the price the ESOP was offering. On

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[18/] CR 105, Exh. F at 17.

[19/] CR 105 at ¶ 27.

three occasions in the same time frame as the ESOP purchase, Larson offered a portion of his shares for sale to the corporation—not at the $9.78 received by the ESOP participants—but at prices ranging from $14.75 to $18.75 per share.[20/]

B. Larson's Complaint

Larson did not file his original Complaint until May 27, 1987, a year and five months after the closing of the ESOP sale.[21/] Invoking federal jurisdiction under SEC Rule 10b-5 and RICO, the Complaint and subsequent First Amended Complaint allege parallel individual and derivative counts, each based upon the same alleged transactions.[22/] As to the counts brought in his individual capacity, Larson alleges that the "Dumke group," promised that Round

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[20/] CR 105 at Exh. I-K.

[21/] CR 1.

[22/] CR 1; CR 149.

Table would continue to be run exactly as it had been run under his management.[23/] According to Larson, that promise was fraudulently made by the Dumke group with no intention of performance.[24/] The First Amended Complaint then contains a laundry list of "speculative business ventures" and other actions taken by the Dumke group "contrary to the above representations" and "in furtherance of their scheme to defraud Larson", including establishment of the ESOP.[25/] The derivative counts mirror Larson's individual claims but allege damage to the corporation.

The ESOP transaction was at the center of Larson's motivation for bringing this action. Because Larson was the only Round Table shareholder who,

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[23/] CR 149 at ¶28.

[24/] CR 149 at ¶285.

[25/] CR 149 at ¶286.

ignoring management's advice, had refused to tender his shares for sale to the ESOP, he alone would benefit from rescission of the ESOP. Rescission of the ESOP would benefit Larson by freeing cash—presently committed to repaying the loan used to finance the ESOP—for dividends, but would harm every other shareholder and employee of Round Table by requiring the employee-shareholders to relinquish the stock which they are eligible to receive from the ESOP, and requiring the original shareholders to refund the tax advantaged sales price which they received from selling a portion of their shares to the ESOP. Rescission of the ESOP would also damage Round Table by destroying employee moral, increasing employee turnover, and exposing Round Table to lawsuits by its employees for breach of contract and promissory estoppel.

C. The District Court's Order Finding Larson to be an Inadequate Representative Under F.R.Civ.P. 23.1

Because Larson's lawsuit, especially with respect to the ESOP, was so obviously antagonistic to the best interests of the corporation, its employees, and all of its other shareholders, Round Table moved to dismiss the derivative counts of Larson's Complaint under F.R.Civ.P. 23.1 on grounds of inadequacy of representation. Every shareholder other than Larson submitted a declaration opposing Larson's representation and supporting dismissal of the derivative counts.[26/]

In his Order granting the motion, the District Court Judge, Hon. Lowell Jensen, found that a combination of factors lead to the conclusion that Larson was an inadequate representative under Rule 23.1:

[26/] CR 219-234.

> Defendant Round Table Pizza Inc. has met its burden of demonstrating that Larson does not fairly and adequately represent similarly situated shareholders.
>
> * * * *
>
> This Court finds that economic antagonism clearly exists between plaintiff and the other shareholders in relation to the ESOP as well as the higher price plaintiff has attempted to obtain for his stock. Furthermore, this Court finds that plaintiff has no support whatsoever from other shareholders for this lawsuit; in fact, he faces universal opposition.[27/]

Larson moved for reconsideration.[28/] In denying the motion, Judge Jensen affirmed his prior finding of Larson's economic antagonism to the other shareholders, and found Larson to be economically antagonistic to the corporation as well:

> Finally, this Court affirms its finding of economic antagonism in the March 22, 1988 Order. Plaintiff argues that "economic antagonism" refers to a conflict of interest between plaintiff and the corporation. Even accepting that

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27/ Appendix II at A-35-36.

28/ CR 318.

> analysis, this Court finds economic antagonism exists between plaintiff's position that continuance of the ESOP is detrimental to the economic health of the corporation and the position of the corporation that rescission of the ESOP would harm the corporation.[29/]

D. The Opinion of the Ninth Circuit Court of Appeals

Invoking the Ninth Circuit's jurisdiction under 28 U.S.C. § 1291, Larson appealed the District Court's order. The appellate panel found that the issue of whether Larson fairly and adequately represented the shareholders of Round Table turned upon a single issue: "whether, as found by the trial court, [Larson] sought to rescind an Employee Stock Option Plan (ESOP)." The panel agreed with the District Court that if Larson had sought to rescind the ESOP, there is a "strong argument" that he is an inadequate representative because he is "economically antagonistic" towards the corporation and all other

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29/ Appendix III at A-46.

shareholders.[30] The panel held, however, that there was "no support in the record" for the District Court's conclusion that Larson had sought rescission of the ESOP:

> We consider the issue to be extremely close. It is one that could not be decided solely by the briefs, oral argument, and excerpts of record submitted by the parties; rather, we had to make a painstaking study of the trial court record to determine what actually took place. With the advantage of time for careful review, we have concluded that recision of the ESOP was not formally requested, and accordingly the major factual predicate of the trial court's decision finds no support in the record. We reverse.[31]

The panel explained its ruling as follows:

> We conclude, that as to the ESOP, there was no demand for equitable relief, only a claim for money damages. The district court did not determine that an award of monetary damages would be detrimental to the corporation or other minority

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[30] 900 F.2d at 1364; Appendix I at A-7.

[31] 900 F.2d at 1364; Appendix I at A-7 (emphasis added).

> shareholders. . . . Larson's request for money damages that resulted from alleged improprieties in establishment of the ESOP, does not in and of itself make Larson an inadequate representative.[32/]

E. The Denial of the Petition for Rehearing

Contrary to the Ninth Circuit panel's opinion, the record is in fact replete with admissions by Larson and his counsel that Larson was seeking rescission of the ESOP. (*See* discussion of the uncontroverted evidence at pp. 22-27, *infra.*) Because Larson did not contest that he was seeking rescission of the ESOP,[33/]

[32/] 900 F.2d at 1368; Appendix I at A-23 (emphasis added).

[33/] Indeed, in his Opening Brief Larson reaffirmed his demand for rescission of the ESOP:

> Thus, when Mr. Larson sought to rescind the ESOP in the derivative action, all other shareholders, whose interests are necessarily adverse, understandably opposed the lawsuit. Larson's Opening Brief at 3.
>
> * * * *
>
> All of these remaining shareholders personally benefited from the sale of

(continued...)

however, that evidence was not called to the appellate panel's attention in Round Table's Brief in Opposition or at oral argument. Thus, the panel "... had to make a painstaking study of the trial court record to determine what actually took place"[34/] precisely because neither side argued the issue.

After the Ninth Circuit panel issued its Opinion reversing the District Court—and Round Table saw that the decision was based solely upon the panel's clearly erroneous finding on an uncontested issue—Round Table of course filed a Petition for Rehearing and Suggestion for Rehearing En Banc pointing out the panel's obvious oversight. Rather than admit that the panel's self-described "painstaking

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[33/](...continued)

> their shares to the ESOP and would be required to return the money they received if Mr. Larson prevailed on the ESOP claim.

Larson's Opening Brief at 20 (emphasis added).

[34/] 900 F.2d at 1364; Appendix I at A-7.

study of the trial court record" had been deficient, however, the Ninth Circuit denied the Petition for Rehearing. Thus, unless the Supreme Court exercises its supervisory powers under Supreme Court Rule 10, the District Court's correct decision will be reversed based solely upon a finding by the appellate panel which is so obviously inconsistent with the facts that Larson did not even raise the issue.

F. The Court of Appeals' Conclusion That Larson Was Not Seeking To Rescind The ESOP Is Demonstrably Wrong

In retrospect, it is not surprising that initially the Court of Appeals may have had difficulty determining whether Larson was seeking rescission of the ESOP. In the early stages of this litigation Larson assiduously attempted to conceal his intentions regarding rescission of the ESOP in the hopes he could garner support and favorable testimony on the other aspects of his case from the minority shareholders. Thus, as discussed in the Court of

Appeals' Opinion, Larson's original Complaints did not include an express prayer for rescission of the ESOP, nor did it name all Round Table employees and shareholders who benefitted from the ESOP as defendants, and at one point Larson stated he was abandoning his rescission claim.[35/]

Larson was forced to admit in deposition, however, that he wanted rescission of the ESOP "as part of this lawsuit."[36/] And as soon as Larson realized that the minority shareholders were not going to support his lawsuit, his true intentions emerged. Larson's Declaration dated June 17, 1988 states:

> [T]he non-defendant shareholders have not altered or abandoned their claims that they are antagonistic to me with respect to the ESOP. Based on this ... it is apparent to me that these shareholders are more interested in their

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35/ CR 257 at ¶ 5.

36/ Exhibit B to Martel declaration, CR 219, 20:6-15 (excerpting Larson deposition, vol. VI, 11/18/87, 852:6-15).

> own short-term personal financial gain than in the long-term financial health of Round Table. For these reasons, I hereby withdraw my offer not to seek to rescind the ESOP.[37]

Not only did Larson and his counsel openly admit that they were seeking rescission, but they sought to amend Larson's First Amended Complaint to name as defendants all of Round Table's minority shareholders, almost all of its employees (i.e. those whose tenure made them eligible for an allocation of shares from the ESOP), and the ESOP Administrative Committee. The reason for the proposed amendment was explained in Larson's Memorandum of Points and Authorities in Support of Motion for Leave to Amend as being to "... enable the Court to fashion a fully effectual rescissionary remedy."[38]

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[37] CR 319 at ¶ 9, 4:20-5:4 (emphasis added).

[38] CR 317 at 2:11-12.

In that Memorandum of Points and Authorities, Larson's counsel unequivocally stated:

> In the present case plaintiff has requested, on Round Table's behalf, rescission of the ESOP transaction.[39/]

The phrasing is in the past tense: Larson "has" requested rescission. According to Larson's counsel, Mr. Burns, when he took over the case from other lawyers in his firm, he realized that the attorneys who had previously handled the case had inadvertently failed to join the parties necessary to Larson's rescission claim. At the August 31, 1988 hearing before the District Court, Mr. Burns stated:

> The amendment can be placed at my doorstep because, again, when I came into this case ... the next question I asked was, "Who are the defendants in the rescission claim?" And when I was told, my next question was, "Is that all of the purchasers and sellers?" And when I was told, "No," my query was, "Why aren't those people joined? If there is to be a rescission, an effective, a valid

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39/ CR 317 at 5:6-7 (emphasis added).

> rescission, all of those people have to be involved, they are defendants."[40/]

While Round Table believes that Larson's failure initially to join the employees and minority shareholders was more a calculated tactic to garner support and favorable testimony than an oversight, either way, Mr. Burns is clearly on record as stating that Larson's failure to join the necessary parties earlier was not indicative of a lack of intent to seek rescission of the ESOP.

Indeed, even in his Opening Brief in the Court of Appeals Larson tacitly conceded that he was seeking rescission of the ESOP:

> Thus, when Mr. Larson sought to rescind the ESOP in the derivative action, all other shareholders, whose interests are necessarily adverse, understandably opposed the lawsuit.[41/]
>
> * * * *

40/ Reporter's Transcript of August 31, 1988 hearing, 14:8-17 (emphasis added).

41/ Larson's Opening Brief at 3 (emphasis added).

> All of these remaining shareholders personally benefited from the sale of their shares to the ESOP and would be required to return the money they received if Mr. Larson prevailed on the ESOP claim.[42]

How the Court of Appeals in its "painstaking study of the trial court record" missed all of these clear admissions by Larson and his counsel that Larson was seeking to rescind the ESOP is unknown. The most that can be said in support of the Court of Appeals' decision is that it at best rewards Larson's sloppy pleading, and at worst, his gamesmanship, by holding that "[t]here was no demand for recision of the ESOP in any pleading filed by the plaintiff."[43]

The District Court, by contrast, was in a better position to observe Larson and his counsel and, notwithstanding the vagueness of Larson's initial pleadings, correctly perceived from the beginning that

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[42] Larson's Opening Brief at 20 (emphasis added).

[43] 900 F.2d at 1367; Appendix I at A-22.

rescission of the ESOP was at the heart of Larson's derivative claims. The District Court's judgment in this regard was ultimately vindicated when Larson moved for leave to amend his First Amended Complaint to expressly pray for rescission of the ESOP,[44] and to join as defendants the minority shareholders, employees, and ESOP Administrative Committee so as to "... enable the Court to fashion a fully effectual rescissionary remedy."[45] The Court of Appeals' conclusion is demonstrably wrong.

REASONS FOR GRANTING THE WRIT

An exercise of this Court's jurisdiction is mandated on two recognized grounds under Supreme

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[44] The prayer of Larson's [Proposed] Amendments to First Amended Complaint (which is shown on the Clerk's docket sheet following CR 317 as being "RECEIVED"), states:

> 11a. For an Order that the ESOP transaction be rescinded and that RTPI be made whole as a result of the wrongs in that transaction.

[45] CR 317, 2:11-12.

Court Rule 10.1(a): (1) in exercise of this Court's power of supervision over "... far depart[ures] from the accepted and usual course of judicial proceedings"; and (2) because the Court of Appeals, although espousing the correct "abuse of discretion" standard of review, in fact substituted its discretion for that of the District Court, thereby rendering a decision "in conflict with decision[s]" of all other federal appellate Courts regarding the proper standard of review.

A. A Writ of Certiorari Should Issue In Exercise Of This Court's Power Of Supervision Over "... Far Depart[ures] From The Accepted And Usual Course Of Judicial Proceedings"

Supreme Court Rule 10.1(a) enumerates the character of reasons that will be considered as grounds for review on writ of certiorari. One enumerated ground is:

> When a United States court of appeals ... has so far departed from the accepted and usual course of judicial proceedings ... as to call for an exercise of this Court's power of supervision.

Cases discussing this provision of Rule 10 are understandably few because either the acceptance or denial of a petition for certiorari moots the issue. Nevertheless, in *New York City Transit Authority v. Beazer*, 440 U.S. 565 (1979), the Supreme Court explained its reason for granting certiorari as follows:

> The Court of Appeals affirmed [a District Court order declaring a Transit Authority regulation unconstitutional] without reaching the [potentially dispositive] statutory question. The departure by those courts from the procedure normally followed in addressing statutory and constitutional questions in the same case, as well as concern that the merits of these important questions had been decided erroneously, led us to grant certiorari.[46/]

Similarly, in this case the appellate panel's actions in (1) conducting its own "painstaking study of the trial court record" on an issue not even raised by the parties, (2) failing to discover the clear and uncontroverted statements by Larson and his counsel

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[46/] 440 U.S. at 570-571 (emphasis added).

that Larson was seeking rescission of the ESOP, and (3) refusing to admit its error when confronted with those statement in the Petition for Rehearing, constitute a "departure by [that] Court from the procedures normally followed" and raise "concern that the merits of these important questions had been decided erroneously." Accordingly, as in *New York Transit Authority v. Beazer*, certiorari should be granted.

B. A Writ Of Certiorari Should Issue To Maintain Uniformity Of Decision Regarding The Standard Of Review Of District Court Determinations Of Adequacy Of Representation Under F.R.Civ.P. 23.1

The settled standard of review for determinations of adequacy of representation under Rule 23.1 is "abuse of discretion."[47/] Under this

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47/ *Hornreich v. Plant Industries, Inc.*, 535 F.2d 550, 552 (9th Cir. 1976)("under Rule 23.1, we will not overturn a determination upon appeal unless it is

(continued...)

standard, the trial court's findings of fact are not to be set aside unless "clearly erroneous."[48] A finding of fact is not clearly erroneous unless (1) there is "no evidence on which [the District Court] rationally could have based that decision,"[49] or (2) the reviewing

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[47](...continued)
shown that the district court abused its discretion"); *Owen v. Modern Diversified Industries, Inc.*, 643 F.2d 441, 443 (6th Cir. 1981) (citing *Hornreich*) ("[t]he issue of whether a stockholder can fairly and adequately represent the corporation and other stockholders in a derivative action under Rule 23.1 address[es] itself to the sound discretion of the district court."); *accord Lewis v. Curtis*, 671 F.2d 779, 788 (3rd Cir. 1982), *cert. denied*, 459 U.S. 880 (1982); *Rothenberg v. Security Management Co., Inc.*, 667 F.2d 958, 960 (11th Cir. 1982); *Roby v. St. Louis Southwestern Ry. Co.*, 775 F.2d 959, 961 (8th Cir. 1985); *Becker v. Schenley Industries, Inc.*, 557 F.2d 346, 348 (2nd Cir. 1977).

[48] *Dollar Rent-A-Car v. Travelers Indemnity Co.*, 774 F.2d 1371, 1374 (9th Cir. 1985); *Sports Form, Inc. v. United Press International*, Inc. 686 F.2d 750, 752 (9th Cir. 1982).

[49] *Petition of Hill*, 775 F.2d 1037, 1040 (9th Cir. 1985); *Premium Service Corp. v. Sperry & Hutchinson Co.*, 511 F.2d 225, 229 (9th Cir. 1975); *Song Jook Suh v. Rosenberg*, 437 F.2d 1098, 1102 (9th Cir. 1971).

court "is left with a definite and firm conviction that a mistake has been committed."[50/]

The Court of Appeals based its decision on the prong of the "clearly erroneous" test which calls for reversal where there is "no evidence on which [the District Court] rationally could have based that decision."[51/] As discussed above, the Court of

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50/ *Parker v. Joe Lujan Enterprises*, 848 F.2d 118, 121 (9th Cir. 1988); *Dollar Rent-A-Car v. Travelers Indemnity Co.*, 774 F.2d 1371, 1374 (9th Cir. 1985); *United States v. Sumitomo Marine and Fire Ins. Co., Ltd.*, 617 F.2d 1365, 1369 (9th Cir. 1980).

51/ The Court of Appeals' Opinion states:

> Larson's key argument before us is that the foundation of the district court's decision--that he sought to unscramble the scrambled corporate eggs by rescinding the ESOP --has no support in the record and that the district court erred in concluding that he sought to rescind the ESOP.
>
> * * * *
>
> [W]e have concluded that recision of the ESOP was not formally requested, and accordingly the major factual predicate of the trial court's decision finds no support in the record. We reverse.

(continued...)

Appeals' Opinion in this respect is demonstrably wrong. There was abundant and uncontradicted evidence in the record to support the finding that

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[51]/(...continued)

> 900 F.2d at 1366 and 1364; Appendix I at A-16 and A-7 (emphasis added).
>
> The Court of Appeals did not even purport to base its decision on the second prong of the "abuse of discretion" / "clearly erroneous" test. Indeed, the Court of Appeals not only failed to state that it was "left with a definite and firm conviction that a mistake has been committed", but in fact stated quite the opposite:
>
> > [O]ur decision essentially turns on whether, as found by the trial court, the plaintiff sought to rescind an Employee Stock Option Plan (ESOP). If that was the relief sought, there exists a strong argument that the plaintiff could not qualify as an adequate representative because he was "economically antagonistic" toward the corporation and other shareholders. Rule 23.1, F.R.Civ.P. We consider the issue to be extremely close.
> >
> > * * * *
> >
> > This has been a difficult case to decide.
>
> 900 F.2d at 1364 and 1369; Appendix I at A-7 and A-30 (emphasis added).

Larson was seeking rescission of the ESOP. The Court of Appeals' decision should therefore be reversed and Judge Jensen's judgment upheld.

Indeed, if allowed to stand, the instant decision "conflicts with the decision[s]" of all other federal courts regarding the proper standard of review of adequacy of representation under Rule 23.1.[52/] Although the Court of Appeals articulated the correct standard of review[53/] and disavowed any intent to substitute its discretion for that of the District

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52/ A conflict within a Circuit, as well as conflicts between Circuits, creates sufficient grounds to grant certiorari. *John Hancock Mut. Life Ins. Co. v. Bartels*, 308 U.S. 180, 181 (1939); *Dickinson v. Petroleum Conversion Corp.*, 338 U.S. 507, 508 (1950); *Maggio v. Zeitz*, 333 U.S. 56, 59-60 (1948).

53/ 900 F.2d at 1364; Appendix I at A-8:

> "This court reviews the district court's determination as to adequacy of representation under Rule 23.1, for abuse of discretion."

Court,[54/] it in fact independently reviewed and weighed the evidence and substituted its factual determinations for the trial court's in reaching at least two of its conclusions: (1) that Larson was not seeking rescission of the ESOP; and (2) that Larson was not seeking to obtain a premium price for his shares.

1. The Court Of Appeals Impermissibly Substituted Its Discretion For That Of The District Court In Concluding That Larson Was Not Seeking To Rescind The ESOP

The Court of Appeals concluded that " ... as to the ESOP, there was no demand for equitable relief." As discussed above, this conclusion is demonstrably wrong. But even if the point were arguable, the

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54/ 900 F.2d at 1369; Appendix I at A-30:

> "We have set forth our reasoning in detail to demonstrate that we are not substituting our discretion for that of the able trial court."

District Court found, on abundant evidence, that Larson was seeking to rescind the ESOP. The Court of Appeals' decision to the contrary is an improper substitution of its discretion for that of the District Court.

2. The Court of Appeals Impermissibly Substituted Its Discretion For That Of The District Court With Respect To Whether Larson's Motion In Bringing This Suit Was To Obtain A Premium Price For His Shares

The District Court found that Larson's motivation in bring this suit was to obtain a premium price for his shares:

> This Court finds that economic antagonism clearly exists between plaintiff and the other shareholders in relation to the ESOP as well as the higher price plaintiff has attempted to obtain for his stock.[55/]

55/ Appendix II at A-36 (emphasis added).

The Court of Appeals disagreed with this finding, explaining its conclusion as follows:

> The Dumke Group responds that Larson's derivative suit is a "strike suit," that his only motivation in bringing this suit was to "achieve the sale of his Round Table stock at a premium price." This is supported by the statement of Mr. Toldrian concerning a conversation between him and Larson. On balance, we are not convinced that Larson's offer to sell some of his shares was sufficient to support the district court's holding that he was not an adequate representative. We are sophisticated enough in derivative suit litigation to recognize that the spectre of a strike suit may be very real. What we know as men and women we must not forget as judges. We know that many cases are eventually settled by having individual defendants purchase the plaintiffs' shares, often at a price in excess of market value. On the state of the record before us, however, we are unable to conclude that this is a strike suit.[56/]

The question of Larson's motivation for bringing this suit—even if deemed a "mixed question

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56/ 900 F.2d at 1369; Appendix I at A-28-29 (emphasis added).

of law and fact"—is subject to review under the "clearly erroneous" standard because it involves a determination of "state of mind."[27/] Contrary to that standard of review, however, the Court of Appeals substituted its determination for that of the District Court regarding Larson's "state of mind," and concluded that "on balance, we are not convinced." The Court of Appeals reached this conclusion notwithstanding (1) the acknowledged reality of the threat of a strike suit; (2) a direct admission by Larson to Mr. Toldrian that he had brought his suit

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27/ *U.S. v. McConney*, 728 F.2d 1195, 1203 (9th Cir. 1984) ("[t]here are, however, some types of mixed questions that are exceptions to this general predominance of factors favoring de novo review. First, there are those mixed questions in which the applicable legal standard provides for a strictly factual test, such as state of mind, and the application of law to fact, consequently, involves an 'essentially factual' inquiry."); *See also*, *Pullman-Standard v. Swint*, 456 U.S. 273, 288 (1982).

to obtain a premium price;[38/] and (3) circumstantial

38/ The declaration of Thomas Toldrian, Round Table's former Chief Financial Officer, states:

> In October, 1987, in a telephone conversation between Mr. Larson and myself, Mr. Larson informed me that his motivation in bringing this action is to achieve the sale of his own Round Table stock at a premium price.

CR 232 at ¶ 13. Although Larson has denied that he intended to extract a premium (*see* Opening Brief at 43, n.40; CR 257 at ¶6, CR 319 at ¶8), he has never once denied making the statement. *See id.* Judge Jensen was clearly entitled to rely upon Mr. Toldrian's unrebutted testimony in making a factual finding that Larson is seeking, by this lawsuit, to extract a premium for his shares. CR 291 at 3:12-15.

evidence,[39/] including actual offers by Larson to sell shares at a premium price.

The Court of Appeals' explanation that "on balance, we are not convinced" highlights that this is a classic case of a reviewing court saying one thing—acknowledging an abuse of discretion standard of review—while doing another—weighing evidence and substituting its discretion for that of a trial court. This is contrary to settled Supreme Court and Court

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39/ The very existence of Larson's ESOP rescission claim, which Larson concedes could only be brought derivatively (CR 344 at 6), strongly suggests that his derivative action is brought as a "strike suit." Larson had standing as an individual shareholder to have sued in 1985 to enjoin the ESOP's implementation. *See Heckmann v. Ahmanson*, 168 Cal.App.3d 119, 214 Cal.Rptr. 177 (1985); *Norlin Corp. v Rooney, Pace Inc.*, 744 F.2d 255, 265 (2nd Cir. 1984); *Castle v. Cohen*, 676 F.Supp. 620, 630 (E.D. Pa. 1987), *aff'd in part*, 840 F.2d 173 (3d Cir. 1988). He did not do so; he did not even register an objection to the formation of the ESOP. Indeed, his representatives on the Board of Directors voted for the ESOP. CR 105 at Exh. B-D. Instead, he sued a year and a half later; after Round Table had rejected several of his offers to sell his shares for a premium price, after all the other shareholders had sold their stock in a tax advantaged transaction; and after valuable employee rights in the ESOP had vested.

of Appeals authority[50] A writ of certiorari is therefore necessary to maintain uniformity in decisions regarding the standard of review for district court determinations of adequacy of representation under Rule 23.1

CONCLUSION

The Court of Appeals reversed the District Court on a factual ground not argued by any of the litigants. In doing so, the Court of Appeals not only impermissably substituted its discretion for that of the District Court, but made an obvious and dispositive error. It then refused to correct that error on a Petition for Rehearing. The case compels exercise by the Supreme Court of its supervisory jurisdiction under Supreme Court Rule 10 to correct a "far depart[ure] from the accepted and usual course of

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[50] *See* n. 47, *supra*.

judicial proceedings" and to assure uniformity among the Circuits regarding the standard of review.

DATED: September 24, 1990

Respectfully submitted,

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APPENDIX I
[900 F.2d 1363]

William R. LARSON, individually and derivatively on Behalf of Round Table Pizza, Inc., Plaintiff-Appellant,

v.

Richard A. DUMKE, Scott O. Bergren, Norman E. Dean, Frederick L. Doar, Paul J. Miller, Robert C. Scheidemann, Charles A. McPhee, Jr., Anne W. Barron, Christopher G. Gillam, George P. Kailis, Round Table Pizza, Inc., a California Corporation, Hills Bros. Coffee, Inc., a Delaware Corporation, and Aussies Enterprises, Inc., d/b/a Bonza Tucker, a California Corporation, Defendants-Appellees.

Nos. 88-15440, 89-15124.

United States Court of Appeals, Ninth Circuit.

Argued and Submitted Dec. 14, 1989.

Decided April 9, 1990.

Shareholder brought derivative action on behalf of corporation, based on alleged improprieties in establishment of employee stock option plan. The United States District Court for the Northern District of California, D. Lowell Jensen, J., dismissed action, and plaintiff appealed. The Court of Appeals,

Aldisert, Senior Circuit Judge, sitting by designation, held that: (1) plaintiff did not make meaningful demand for rescission of plan and could adequately represent other shareholders, and (2) plaintiff was not similarly situated with other shareholders and could bring action without their support.

Reversed.

1. Federal Courts 817

Court of Appeals reviews district court's determination as to adequacy of representation in shareholder's derivative suit for abuse of discretion. Fed.Rules Civ.Proc.Rule 23.1, 28 U.S.C.A.

2. Corporations 2O7.1

Adequate representative in shareholders' derivative action must have capacity to vigorously and conscientiously prosecute derivative suit and be free from economic interests that are antagonistic to interests of class. Fed.Rules Civ.Proc.Rule 23.1, 28 U.S.C.A.

3. Corporations 2O7.1

Factors to be considered in determining adequacy of representation in shareholders' derivative action include: indication that plaintiff is not true party in interest; plaintiff's unfamiliarity with litigation and unwillingness to learn about suit; degree of control exercised by attorneys over the litigation; degree of support received by plaintiff from other shareholders; lack of any personal commitment to action on part of representative plaintiff; remedy sought by plaintiff in derivative action; relative magnitude of plaintiff's personal interests as compared to his or her interest in derivative action itself; and plaintiff's vindictiveness toward defendants. Fed.Rules Civ.Proc.Rule 23.1, 28 U.S.C.A.

4. Corporations 2O7.1

Shareholder who brought derivative action seeking money damages resulting from alleged improprieties in establishing employee stock option

plan did not make meaningful demand for rescission of the plan so as to make him an inadequate representative of other shareholders who had sold their stock to the plan; shareholder did not demand equitable relief, did not join other minority shareholders as defendants, and made only claim for money damages. Fed.Rules Civ.Proc.Rule 23.1, 28 U.S.C.A.

5. Corporations 207

Single shareholder may bring derivative suit. Fed.Rules Civ.Proc.Rule 23.1, 28 U.S.C.A.

Degree of support putative plaintiff in derivative action receives from other shareholders is factor that should be considered in determining adequacy of representation; weight given to this factor is usually left to discretion of trial court. Fed.Rules Civ. Proc.Rule 23.1, 28 U.S.C.A.

7. Corporations 207.1

Shareholder who owned 23.4% of corporation's stock was not similarly situated with other shareholders, permitting him to bring derivative suit based on alleged improprieties in establishing employee stock option plan, without support of other shareholders; other shareholders were either defendants or had economic interest in supporting current management and benefited from formation of plan. Fed.Rules Civ. Proc.Rule 23.1, 28 U.S.C.A.

8. Corporations 207.1

Shareholder's derivative action challenging alleged improprieties in establishment of employee stock option plan was not a "strike suit" that made shareholder inadequate class representative, although shareholder had previously offered to sell his shares to corporation at price greater than that contained in plan. Fed.Rules Civ. Proc.Rule 23.1, 28 U.S.C.A.

Peter W. Davis, James C. Martin and Paul D. Fogel, Crosby, Heafey, Roach & May, Oakland, Cal., for plaintiff-appellant.

Jerome I. Braun, Farella, Braun & Martel, San Francisco, Cal., for defendant-appellee Round Table Pizza, Inc.

John E. Rumel, Broad, Schulz, Larson & Wineberg, San Francisco, Cal., for other defendants-appellees.

Appeal from the United States District Court for the Northern District of California.

Before ALDISERT,* TANG and FLETCHER, Circuit Judges.

ALDISERT, Senior Circuit Judge:

We are to decide if the district court abused its discretion in dismissing a derivative suit brought by a

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* Ruggero J. Aldisert, Senior Judge, United States Court of Appeals for the Third Circuit, sitting by designation.

substantial shareholder on behalf of a corporation. Other issues are present, but our decision essentially turns on whether, as found by the trial court, the plaintiff sought to rescind an Employee Stock Option Plan (ESOP). If that was the relief sought, there exists a strong argument that the plaintiff could not qualify as an adequate representative because he was "economically antagonistic" toward the corporation and other shareholders. Rule 23.1, F.R.Civ.P.

We consider the issue to be extremely close. It is one that could not be decided solely by the briefs, oral argument, and excerpts of record submitted by the parties; rather, we had to make a painstaking study of the trial court record to determine what actually took place. With the advantage of time for careful review, we have concluded that recision of the ESOP was not formally requested, and accordingly the major factual predicate of the trial court's decision finds no support in the record. We reverse.

[1] Jurisdiction was proper in the trial court based on 28 U.S.C. § 1331. Jurisdiction on appeal is proper based on 28 U.S.C. § 1291. The appeal was timely filed under Rule 4(a), F.R.App.P. This court reviews the district court's determination as to adequacy of representation under Rule 23.1, for abuse of discretion. *Hornreick v. Plant Industries, Inc.*, 535 F.2d 550, 552 (9th Cir.1976).

I.

William Larson, founder and once sole owner of Round Table Pizza, is the unsuccessful derivative plaintiff who has brought this appeal to us. In 1979, he sold a 75 percent interest in Round Table to Dumke and Associates, a group consisting of Richard Dumke, Norman Dean, Frederick Doar, Paul Miller and Robert Scheidemann. They, along with Scott Bergren, Thomas Toldrian and others, became members of the board of directors. Anne Baron was,

at various times, Vice President-Finance, Treasurer and Chief Financial Officer and Charles McPhee was General Counsel and Secretary. These named individuals, except Larson and Toldrian, constitute the "Dumke group."

Sometime after 1979, Larson became dissatisfied with the Dumke group. He alleges that through fraud, misrepresentation and deceit, the group misappropriated funds and business opportunities from Round Table for its own benefit. He also claims that as a result of the group's actions, Round Table, which enjoyed increasing profitability before 1978, has experienced little or no profit, has paid no dividends to shareholders and has failed to experience anywhere near the $6 million to $8 million annual profit expected of a successful franchise operation of its size.

In May of 1987, Larson filed suit.

A.

Larson's most significant claim, for purposes of this appeal, are his allegations of fraud and mismanagement in connection with implementation of the Employee Stock Option Plan. On April 3, 1985, an ESOP proposal was made to the Round Table board of directors. Following discussion, the plan was adopted by a unanimous vote, including the votes of Larson's representatives on the board of directors. Later that year a plan disclosure statement was circulated to all shareholders, including Larson. Shareholders were offered $9.78 per share, based on Round Table's calculated net worth of $30 million. All shareholders, except Larson, opted for full participation, or 30 percent of each shareholders' shares.

Larson argued that he did not participate in the plan because he realized that the ESOP was primarily a scheme for the Dumke group to pull cash

out of Round Table that the company could ill afford to lose. The Dumke group responded that Larson refused to participate in the ESOP because he wanted more money for his shares. They noted that within the same time frame as the ESOP purchase, Larson offered some of his shares for sale at prices ranging between $14.75 and $18.75 a share.

To establish the ESOP, Round Table incurred approximately $9 million in debt: a $6 million loan from Wells Fargo Bank, and $3 million in promissory notes to participating shareholders at 121/2 percent interest. Because it is a closely held corporation, 98 percent of the ESOP purchase price, or $8.82 million ($5.8 million in cash) went to the Dumke group.

Larson alleged breach of fiduciary duty, fraud and misrepresentation in connection with implementation of the ESOP. He contended that the $30 million appraisal of Round Table's net worth was unrealistic. He further alleged that the 121/2 percent

interest payable on notes to shareholders is excessive and the product of collusion. He fears that company profits will be used exclusively for debt maintenance at the expense of shareholder dividends.

B.

Larson also sought money damages on behalf of the corporation for what he calls improper influence by the Dumke group in certain business transactions. For the sake of brevity, we list only some of these transactions. One involved the purchase by Round Table of Far West Pizza, a franchise consisting of several Round Table restaurants. Another concerned the purchase of an interest in Aussies, an Australian-sponsored venture to franchise spitroasted chicken restaurants. Still another related to a proposal in which the corporation was to purchase Buffalo Chips, Inc., a gourmet potato chip manufacturer.

It is Larson's contention, *inter alia*, that Round Table paid too high a price for Far West, that the corporation's interest in Aussies was improperly diluted and that the corporation became mired in unnecessary and costly litigation relating to the Buffalo Chips transaction.

II.

Larson s complaint alleged parallel individual and derivative claims for violations of state and federal securities laws, RICO, firms its finding that plaintiff is not an fraud, breach of fiduciary duty and breach of state and federal securities laws, RICO, fraud, breach of fiduciary duty and breach of contract. It asked for damages as to all Larson derivative counts, recision of the amendments to Round Table's articles of incorporation, and "for such other and further relief as the court may deem just and proper." A jury trial was demanded.

The defendants responded with a motion to dismiss and, alternatively, a motion for a more definite statement. In October, plaintiff filed a First Amended Complaint that repeated the request for damages for the derivative counts, recision of the amendments to the articles of incorporation, and "such other and further relief as the court between may deem just and proper."

It is important to emphasize what is not before us. Larson's claims as an individual do not command our attention in this appeal. Similarly, we do not reach the merits of his derivative claims. Our inquiry tracks a very narrow path: Did the district court abuse its discretion in determining that Larson did not qualify as a derivative plaintiff in this suit on behalf of Round Table Pizza?

III.

Larson's primary contention is that the district court abused its discretion when it refused to grant him status as a Rule 23.1 derivative plaintiff because of conflicts between him and other members of the putative class. The district court explained:

> [T]he term "economic antagonism" also refers to conflicts between representative and class. *Davis v. Comed, Inc.*, 619 F.2d 588, 593-94 *reh. denied* 623 F.2d 28 (6th Cir.1980). Economic antagonism underlies the opposition to this lawsuit: a recision of the ESOP would have the result that those shareholders who sold their stock to the ESOP would have to refund the tax advantaged sales price received for their shares, and those employees who are currently eligible to receive shares would forfeit their rights.

> Accordingly, this Court rejects plaintiff's argument that there are no other similarly situated shareholders, and affirms its finding that plaintiff is not an adequate representative of that "class."

Larson v. Dumke, No. C87-2592, Order, September 8, 1988, at 5 [hereinafter "Order"].

Larson's key argument before us is that the foundation of the district court's decision--that he sought to unscramble the corporate eggs by rescinding the ESOP--has no support in the record and the district court erred in concluding that he sought to rescind the ESOP. He claims the suit asks for money damages on behalf of the corporation only, and that, accordingly, no economic antagonism exists between him and the corporation, or between him and other minority shareholders, that would preclude him from qualifying as a Rule 23.1 plaintiff.

The Dumke group argues that the record clearly shows that Larson requested recision of the ESOP. Alternatively, they maintain a somewhat weaker argument that even in a case limited to money damages, verdict for Larson in favor of the corporation would destroy the effectiveness of its operation. We reject this alternative argument as having no basis in the record. The appellees also contend that Larson cannot qualify as a derivative plaintiff because no other shareholders support his suit. This requires us to decide whether a single shareholder may pursue a derivative suit. Appellee's final argument is that Larson's derivative claims are nothing more than a strike suit designed to have the Dumke group purchase his shares in an amount exceeding market value.

Our inquiry thus resolves itself into two parts: a) an analysis of the requirements for Rule 23.1

representation, and b) an examination of the record to determine precisely what relief was requested.

IV.

Rule 23.1, F.R.Civ.P. dictates when a shareholder may not sue as a derivative plaintiff to enforce the right of a corporation:

> The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association.

In *Hornreich v. Plant Industries, Inc.*, 535 F.2d 550 (9th Cir.1976), we affirmed the district court holding dismissing plaintiff's derivative suit because he was not an adequate representative of similarly situated shareholders. We were convinced that the plaintiff was attempting to use the derivative suit as

leverage in his individual suits against the same defendants. We did not, however, establish criteria for determining adequacy of representation in subsequent cases. We take this opportunity to do so.

[2, 3] An adequate representative must have the capacity to vigorously and conscientiously prosecute a derivative suit and be free from economic interests that are antagonistic to the interests of the class. *See e.g., Lewis v. Curtis*, 671 F.2d 779, 788-89 (3d Cir.), *cert. denied*, 459 U.s. 880, 103 S.Ct. 176, 74 L.Ed.2d 144 (1982); *Owen v. Modern Diversified Industries, Inc.*, 643 F.2d 441, 443-44 (6th Cir.1981) (no antagonistic interests); *GA Enterprises, Inc. v. Leisure Living Communities, Inc.*, 66 F.R.D. 123, 125-127 (D. Mass. 1974), *aff'd*, 517 F.2d 24, 2627 (1st Cir.1975). Other courts have stated certain factors to determine adequacy of representation: "(1) indications that the plaintiff is not the true party in interest; (2) the plaintiff's unfamiliarity with the litigation and

unwillingness to learn about the suit; (3) the degree of control exercised by the attorneys over the litigation; (4) the degree of support received by the plaintiff from other shareholders; (5) the lack of any personal commitment to the action on the part of the representative plaintiff"; *Rotkenberg v. Security Management Co.*, 667 F 2d 958, 961 (11th Cir.1982) (citations omitted), (6) the remedy sought by plaintiff in the derivative action; (7) the relative magnitude of plaintiff's personal interests as compared to his interest in the derivative action itself; and (8) plaintiff's vindictiveness toward the defendants. *Davis v. Comed, Inc.*, 619 F.2d 588, 593-94 (6th Cir. 1980). These factors are "intertwined or interrelated, and it is frequently a combination of factors which leads a court to conclude that the plaintiff does not fulfill the requirements of 23.1." *Id.* at 593. We are satisfied that an evaluation of these factors is important in

determining the adequacy of re presentation by a derivative plaintiff under Rule 23.1.

In determining that Larson was not an adequate representative, the district court relied on:

1. Larson's desire to rescind the ESOP, a remedy that is detrimental to both the minority shareholders and the corporation;
2. The lack of support by minority shareholders for the derivative suit; and
3. Larson's personal interest in securing a higher price for his shares of stock.

We now turn to a discussion of these considerations.

A.

[4] We begin by addressing an issue to which we have devoted much original research and study. After expending hours meticulously examining the

record, this court is convinced that Larson did not make a meaningful demand for recision of the ESOP.

There was no demand for recision of the ESOP in any pleading filed by the plaintiff. This is consistent with plaintiff's request for a jury trial, a remedy available only in cases at law. Further, plaintiff did not join the other minority shareholders as defendants to the derivative suit. The ESOP cannot be rescinded unless the minority shareholders refund the money that they earned when the ESOP was formed and employee shareholders return the shares they purchased from the ESOP. Because these minority shareholders were not joined as defendants, the district court had no power over them and therefore could not order recision.

Indeed, the only mention of possible recision of the ESOP that we have been able to discover was during Mr. Larson's November, 1987 deposition. In response to the question: "[Do you want] to have [the

ESOP] done away with because it was illegally formed," Mr. Larson stated he did. Within three months, Mr. Larson issued a statement assuring the defendants, other shareholders, and the court that he would "not seek to rescind the ESOP transaction."

We conclude, that as to the ESOP, there was no demand for equitable relief, only a claim for money damages. The district court did not determine that an award of monetary damages would be detrimental to the corporation or other minority shareholders. Indeed, if the derivative claim is proved, the damages accrued to the corporation would benefit minority shareholders Larson's request for money damages than resulted from alleged improprieties in establishment of the ESOP, does not in and of itself make Larson an inadequate representative.

B.

In holding that Larson was not an adequate representative, the district court also relied on the lack of support for the derivative suit by non-defendant shareholders. Under the circumstances of this case, we do not deem this factor sufficient to support the district court's exercise of discretion.

[5] Although the cases are not uniform, we are persuaded that a single shareholder may bring a derivative suit. *Halsted Video, Inc. v. Guttillo*, 115 F.R.D. 177, 179-80 (N.D.Ill.1987); *see Nolen v. Shaw-Walker Co.*, 449 F.2d 506, 509 n. 4 (6th Cir.1971). *But compare, Kuzmickey v. Dunmore Corp.*, 420- F.Supp. 226, 230-31 (E.D.Pa. 1976) (one plaintiff alone may not maintain a derivative suit) *with Lewis*, 671 F.2d at 788-89 (one plaintiff who owned 100 shares in a corporation with nearly 8 million shares outstanding was considered an adequate representative under Rule

23.1). Indeed, the district court acknowledged this in its September 8 order. Order at 4.

Larson argues that determination of this issue requires interpretation of the language of Rule 23.1: "[a plaintiff must] represent the interests of shareholders or members *similarly situated* in enforcing the right of the corporation or association." Rule 23.1, F.R.Civ.P. (emphasis supplied). He says that he is not similarly situated to any other shareholder because everyone, except him, benefited from wrongful formation of the ESOP.

[6] We do not support the notion that because a nondefendant shareholder may inadvertently benefit from the wrongdoings of other shareholders, or managers or directors, the non-defendant shareholder does not have the right to oppose a derivative action. The degree of support a putative plaintiff receives from other shareholders, however, is a factor that should be considered in determining adequacy of

representation. The weight given to this factor is usually left to the discretion of the trial court.

[7] We are persuaded that in this case Larson was not similarly situated with the other shareholders. Round Table Pizza is a closely held corporation. Larson owns 23.41 percent of the stock; 38.51 percent is owned by the defendants; 28.77 percent is owned by the ESOP and controlled by the defendants; 7.7 percent is owned by ex-director Toldrian, and the remaining 1.6 percent is distributed among 13 individual shareholders, all of whom are presently or have been employees of Round Table Pizza. Each non-defendant shareholder has an economic interest in supporting the current management: the Dumke group.

Moreover, each non-defendant shareholder benefited from formation of the ESOP. Given the massive quantity of misinformation and confusion surrounding this suit, the minority shareholders may

have reasonably believed that Larson wanted the ESOP rescinded. Were the court to rescind the ESOP, every shareholder except Larson would lose money. There is the very real possibility that in refusing to join with or in actively opposing Larson's efforts, the non-defendant shareholders may have been motivated by individual interests, rather than the good of the corporation. We have concluded that the lack of support for the derivative suit, in and of itself, does not indicate that Larson is an adequate representative.

We conclude, therefore, that in this case, Larson is the only shareholder similarly situated and that he meets the Rule 23.1 qualifications. In so concluding, we emphasize that cases determining when a derivative plaintiff is an adequate representative are fact specific, and that, in the common-law tradition, we are deciding only the facts before us without offering *obiter dictum* as to the legal consequences that would attach to a different set of facts.

C.

[8] Finally, the district court placed some reliance on Larson's offer to sell his shares for an inflated price as a basis for its holding that Larson was not an adequate representative. Larson says that the offers were made to circumvent the new corporate by-laws establishing a right-of-first-refusal as to all Round Table shares. He says he offered 30 percent of his shares at prices ranging between $14.75 and $18.75 a share to be sure the corporation would refuse his offer. This version of the facts is consistent with communications with Round Table management at the time of the offering.

The Dumke group responds that Larson's derivative suit is a "strike suit," that his only motivation in bringing this suit was to "achieve the sale of his Round Table stock at a premium price." This is supported by the statement of Mr. Toldrian

concerning a conversation between him and Larson. On balance, we are not convinced that Larson's offer to sell some of his shares was sufficient to support the district court's holding that he was not an adequate representative. We are sophisticated enough in derivative suit litigation to recognize that the spectre of a strike suit may be very real. What we know as men and women we must not forget as judges. We know that many cases are eventually settled by having individual defendants purchase the plaintiffs' shares, often at a price in excess of market value. On the state of the record before us, however, we are unable to conclude that this is a strike suit.

V.

In considering the factors set forth in Part IV, we conclude that Larson is the true party in interest, that he is familiar with this litigation, that he has a personal commitment to this action, that the remedy

sought can be construed as legitimate for the corporation, that Larson's interest in his personal claims do not outweigh his interest in those asserted on behalf of the corporation, and that notwithstanding the possibility of personal vindictiveness or animosity between Larson and the defendants, it has not been established that Larson is an inadequate representative for the derivative claims.

This has been a difficult case to decide. We have set forth our reasoning in detail to demonstrate that we are not substituting our discretion for that of the able trial court. Our proper role is only to determine whether the district court's broad range of discretion was exceeded at this stage of the proceeding: We hold that it was.

VI.

The judgment of the district court dismissing the derivative claims on behalf of Round Table Pizza

based on Mr. Larson's failure to qualify as an adequate representative, is REVERSED.

APPENDIX II

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

WILLIAM R. LARSON,	)	
	)	
Plaintiff,	)	**C 87 2592 DLJ**
	)	
v.	)	**ORDER**
	)	
RICHARD A. DUMKE, et al.,	)	
	)	
Defendants.	)	
	)	

On March 9, 1988, this Court heard defendants' motion to dismiss the First Amended Complaint. For the following reasons, this Court DISMISSES the derivative counts, Counts I through XVII, and the claim for a breach of the covenant of good faith and fair dealing, Count XXII.

I.

A. The derivative counts and Rule 23.1

Plaintiff William R. Larson, the founder of Round Table Pizza Inc., and a current shareholder, purports to bring this lawsuit both individually and derivatively, on behalf of Round Table Pizza, Inc..

The corporate derivative suit is a species of class action. *See, Fradkin v. Ernst*, 98 F.R.D. 478, 484 (N.D. Ohio 1983). While Fed.R.Civ.P. 23 governs the maintenance of class actions, Fed.R.Civ.P. 23.1 governs corporate derivative suits.

Rule 23.1 establishes several prerequisites to the maintenance of a corporate derivative suit. Two of these prerequisites are relevant to the determination of this motion. First, Rule 23.1 states that plaintiff must make a demand on the Board of Directors to take the desired action or must demonstrate with particularity the futility of that

demand. *Lewis v. Curtis*, 671 F.2d 779, 784 (3rd Cir. 19821.

Second, Rule 23.1 establishes, as a prerequisite to the maintenance of a derivative suit, that plaintiff must "fairly and adequately represent the interests of the shareholders or members similarly situated." Fed.R.Civ.P. 23.1.

I. Demand futility

The First Amended Complaint states that Larson made no demand on the Board because a demand would have been futile. Plaintiff argues that all individual defendants were or are currently directors of Round Table and had knowledge of, participated in, or approved the acts and transactions referred to in the Complaint.

This Court holds that demand would be futile in this context, where the allegations are that the director defendants participated in the wrongdoing,

and in particular, in self-interested transactions. *See, Lewis v. Curtis, supra,* at 787.

2. Adequate Representation

However, this Court holds that the derivative counts must be dismissed on the basis that Larson does not fairly and adequately represent similarly situated shareholders. Defendant Round Table Pizza Inc. has met its burden of demonstrating that Larson does not fairly and adequately represent similarly situated shareholders. *See, Lewis v. Curtis, supra,* at 788, *Kuzmickey v. Dunmore Corp.*, 420 F.Supp. 226, 230 (E.D. Penn. 1976).

The Ninth Circuit has not specifically addressed the issue of the criteria to be used in a determination of fair and adequate representation. However, other circuits have addressed this issue, and listed a number of factors which should be examined in this determination. Relevant factors include whether economic antagonism exists between the representative

and the purported class, and the degree of support plaintiff receives from the shareholders he purports to represent. *Davis v. Comed, Inc.*, 619 F.2d 588, 593-94 (6th Cir. 1980).

This Court finds that economic antagonism clearly exists between plaintiff and the other shareholders in relation to the ESOP as well as the higher price plaintiff has attempted to obtain for his stock. Furthermore, this Court finds that plaintiff has no support whatsoever from other shareholders for this lawsuit; in fact, he faces universal opposition.

Nominal defendant Round Table has submitted with its motion to dismiss the declaration of every single other shareholder stating his or her opposition to the maintenance of this lawsuit. It is not necessary for a derivative plaintiff to have the support of all other shareholders. *See, Nolen v. Shaw-Walker Co.*, 449 F.2d 506, 508 n.4 (6th Cir. 19711.

However, when plaintiff not only has the support of no other shareholders, but in addition, faces universal opposition, it is impossible to understand how a derivative action may be maintained. *See, Kuzmickey, supra*, at 231. Accordingly, this Court concludes that plaintiff does not meet the requirement of Rule 23.1 that he fairly and adequately represent the interests of similarly situated shareholders.

Accordingly, defendant Round Table Pizza Inc.'s motion to dismiss pursuant to Rule 23.1 all derivative counts is GRANTED. These counts are dismissed with PREJUDICE.

II.

A. The claim for breach of the covenant of good faith and fair dealing

In Count XXII, Larson asserts a state claim for tortious breach of the covenant of good faith and fair dealing. He alleges that individual defendants

Dumke, Dean, Doar, Miller and Schneidemann breached this covenant by failing to comply with the terms of the Preincorporation Agreement. The individual defendants respond that no "special relationship" existed between themselves and Larson which would enable him to plead this breach.

California courts have applied the follow criteria to establish a "special relationship":

(1) the parties must be in inherently unequal bargaining positions;

(2) the parties must have had a non-profit motivation;

(3) ordinary contract damages are inadequate;

(4) one party is especially vulnerable;

(5) the other party is aware of this vulnerability.

Wallis v. Superior Court, 100 Cal. App. 3d 1109, 1118 (1984). This Court concludes that the relationship

between Larson and the individual defendants at the time of the Preincorporation Agreement does not fit within the meaning given these criteria by California courts.

The Ninth Circuit has cautioned against extending this cause of action "[i]n the absence of further guidance from the California 'courts concerning the scope of this potentially expansive new theory." *Consolidated Data Terminals v. Digital Data Systems*, 708 F.2d 385, 400 (9th Cir. 1985). Larson asks this Court to extend that law, not to apply it. The Ninth Circuit has stated that such an extension should come from the state courts. Accordingly, defendants' motion for dismissal of the XXII Count is GRANTED.

IT IS SO ORDERED.

Dated: March 21, 1988

D. Lowell Jensen
United States District Judge

APPENDIX III

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

WILLIAM R. LARSON,	)	
	)	
Plaintiff,	)	**C 87 2592 DLJ**
	)	
v.	)	**ORDER**
	)	
RICHARD A. DUMKE, et.al.,	)	
	)	
Defendants.	)	
	)	

On August 31, 1988, this Court heard plaintiff's motions for reconsideration of this Court's March 22, 1988 Order dismissing all derivative claims, or in the alternative, for the entry of a final judgment pursuant to Fed.R.Civ.P. 54(b), and to amend the complaint. This Court also heard defendant Hills Bros.' motion for dismissal.

James E. Burns, Jr., John Missing, and Steven M. Garrett of Brobeck, Phleger, & Harrison appeared on behalf of plaintiff. John S. Martel and Bruce R. MacLeod of Farella, Braun & Martel appeared on

behalf of Round Table Pizza, Inc. Robert R. Cross of Broad, Schulz & Wineberg appeared on behalf of the individual defendants. Elizabeth J. Kuczynski appeared on behalf of Hills Bros.

For the following reasons, this Court DENIES plaintiff's motion for reconsideration, GRANTS plaintiff's motion for a final judgment of the dismissed derivative claims, DENIES plaintiff 's motion for an amendment of the complaint, and GRANTS Hills Bros.' motion for a dismissal of the claims against it.

On March 22, 1988, this Court dismissed all of plaintiff's derivative claims on the grounds that plaintiff failed to meet the requirement of Fed.R.Civ.P. 23.1 of adequate representation. Rule 23.1 states, in pertinent part:

> The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation...

This Court held that plaintiff failed to meet this requirement due to Universal opposition to this lawsuit by the other shareholders, and (2) economic antagonism with the other shareholders. Whether a plaintiff in a derivative action satisfies this requirement is a matter addressed to the trial court's discretion. *Halsted Video. Inc. v. Guttillo*, 115 F.R.D. 177, 179 (N.O. Ill. 1987).

Plaintiff now argues that this Court, in its March 22, 1988 Order, incorrectly applied the requirement of adequate representation. Citing to *Halsted*, plaintiff asserts that he is an adequate representation of the interests of the corporation and need not represent the interests of shareholders with whom he is not similarly situated." *Id.* at 180. Plaintiff claims that no other shareholders are similarly situated to him in that they are all "drinking

at the trough of the ESOP",[1/] and therefore are solely interested in their own short-term financial gain rather than the long-term financial health of the corporation. Therefore, plaintiff asserts, he adequately represents the interests of the corporation and may maintain the derivative causes of action despite Universal opposition, and that the requirement that he represent similarly situated shareholders is satisfied in that he is the only shareholder in this particular "class" of "similarly situated" shareholders.

Plaintiff's argument, that no other Shareholders are similarly situated since they all support the ESOP, defines the shareholder class in terms of who favors the lawsuit (including the rescission of the ESOP).

1/ The employee stock option plan ("ESOP") was formed in 1985 pursuant to federal statutes to enable eligible RTPI employees to acquire shares Of RTPI stock and to provide benefits in the event of retirement, death, or disability. All directors, including plaintiff 's representatives on the Board, voted for the ESOP. The ESOP offered to purchase shares from all Shareholders. However, plaintiff chose not to tender his shares to the ESOP.

This Court does not agree with this definition of the potential class, and is instead persuaded that the requirement of adequate representation in Rule 23.1 must be read to mean the adequate representation of the other minority shareholders. *See*, 7C Wright, Miller, Kane, Federal Practice and Procedure, §1833 at 138 (1986). Thus, "if plaintiff advocates positions inconsistent with the other minority Stockholders or manages the action to the detriment of their interests, he obviously is an inadequate representative." *Id.*, at 139.

This Court finds that the relevant "class: for purposes the requirement of adequate representation includes all minority shareholders as of the time of the formation of the ESOP. The inescapable conclusion based on this definition is that plaintiff is an inadequate representation of the similar Situated Shareholders, who universally oppose the lawsuit.

Plaintiff's reliance on *Halsted Video, supra*, to support his argument that he is a legitimate "class of one", is misplaced. In *Halsted*, the Court held plaintiff need not satisfy the "Similarly situated" requirement to adequately represent the interests of the corporation and maintain a derivative action. *Id.*, at 180. However, Halsted Video was a closely held corporation consisting of five shareholders. Plaintiff alleged corporate looting on the part of the other four shareholders, who were the corporate officers, and sued them as well as their accountant. *Id.* at 178.

By contrast, there simply is no such analogous universally culpable conduct on the part of all other Round Table Shareholders. This Court cannot agree with plaintiff that the other Shareholders' participation in an employee stock option plan constitutes such culpable conduct so as to remove the requirement that plaintiff represent similarly situated shareholders.

Finally, this Court affirms its finding of economic antagonism in the March 22, 1988 Order. Plaintiff argues that "economic antagonism" refers to a conflict of interest between plaintiff and the corporation. Even accepting that analysis this Court finds economic antagonism exists between plaintiff's position that continuance of the ESOP is detrimental to the economic health of the corporation and the position of the corporation that rescission of the ESOP would harm the corporation.

In addition, the term "economic antagonisms also refers conflicts between representative and class. *Davis v. Comed, Inc.*, 619 F.2d 588, 593-94 reh. denied 623 F.2d 28 (6th Cir. 1980). Economic antagonism underlies the opposition to this lawsuit: a rescission of the ESOP would have the result that those Shareholders who sold their stock to the ESOP would have to refund the tax advantaged sales price received for their shares, and those employees who are

currently eligible to receive shares would forfeit their rights.

Accordingly, this Court rejects plaintiff's argument that there are no other similarly situated shareholders, and affirms its finding that plaintiff is not an adequate representative of that "class." Plaintiff's motion for reconsideration of the dismissal of the derivative claims is DENIED.

II.

Plaintiff moves this Court for leave to amend the First Amended Complaint to add as defendants (a) those persons who sold their stock to the Round Table ESOP, (b) a class representative of those individuals who have had Round Table stock allocated to their account from ESOP and (c) the ESOP Administrative Committee. The purpose of this amendment is to add all those parties necessary for the rescission of the ESOP.

By letter to this Court dated August 31, 1988, written to supplement the oral argument, plaintiff's attorney states: "[p]laintiff cannot state a non-derivative claim for rescission of the ESOP."

Since this Court has by this Order denied plaintiffs motion to reconsider the dismissal of the derivative claims, and since plaintiff admits that the claim for rescission of the ESOP, which is the purpose of this amendment, is dependent on the viability of those derivative claims, the proposed amendment is futile.

Fed.R.Civ.P. 15(a) commands that the district court should freely grant leave to amend when justice so requires. *Gabrielson v. Montgomery Ward & Co.*, 785 F.2d 762, 765 (9th Cir. 1986). However, this liberality in granting leave to amend is subject to qualifications, including that the proposed amendment "does not constitute an exercise in futility." *DCD*

Programs Ltd. v. Leighton, 833 F.2d 183, 186 (9th Cir. 1987).

This Court finds that the proposed amendment would be "such an exercise in futility", merely adding to the expense of the litigation Accordingly, plaintiff's motion for leave to amend is DENIED.

III.

Plaintiff moves, in the alternative, for the entry of a final judgment pursuant to Fed.R.Civ.P. 54(b) upon the dismissed derivative claims. Such an entry of final judgment is appropriate in this case. Accordingly, a Judgment will be entered with this Order.

IV.

Finally, defendant Hills Bros. moves for a dismissal of the claims against them on the grounds

that no federal claim stated, and therefore, no subject matter jurisdiction exists.

The only remaining federal cause of action asserted against Hills Bros. is Count III, for a violation of Civil RICO, 18 U.S.C. §1962. This Court requested, and on April 25, 1988, received a RICO case statement from plaintiff. Nowhere in that statement is there any articulation of activity by Hills Bros. which would bring it within the scope of the RICO claim. Thus, plaintiff fails to comply with the requirement of Fed.R.Civ.P. 9(b), to plead fraud with particularity as to defendant Hills Bros. Accordingly, Count III is dismissed with prejudice as to Hills Bros.

The remaining claims against Hills Bros., Counts III, V, X, and XI, are all state law claims. Under the law of the Ninth Circuit, the fact that federal claims have been asserted against other parties does not support continuing jurisdiction over Hills Bros. when no federal claim is stated against it.

Carpenters Southern California Admin. Corp. v. D. & L. Camp Construction. Inc., 738 F.2d 999, 1000 (9th Cir. 1984).

The claims against Hills Bros. are hereby dismissed with prejudice in their entirety.

V.

For the foregoing reasons, this Court DENIES plaintiffs motions for a reconsideration and for leave to amend, GRANTS plaintiff's motion for final judgment on the derivative claim, and GRANTS defendant Hills Bros. motion for dismissal of al claims against it.

IT IS SO ORDERED.

Dated: September 8, 1988.

D. Lowell Jensen
United States District Judge

APPENDIX IV

NOT FOR PUBLICATION

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

WILLIAM R. LARSON, individually and derivatively on behalf of ROUND TABLE PIZZA, INC.,	**Nos. 88-15440 & 89-15124**
	Nos. C 87 259 2 DLJ
Appellant,	
RICHARD M. DUMKE, SCOTT O. BERGREN, NORMAN E. DEAN, FREDERICK L. DOAR, PAUL J. MILLER, ROBERT C. SCHNEIDEMANN, CHARLES A. MCPHEE, JR., ANNE W. BARRON, CHRISTOPHER G. GILLAM, GEORGE P. KAILIS, ROUND TABLE PIZZA, INC., a California Corporation, HILLS BROS. COFFEE, INC., a Delaware Corporation, and AUSSIES ENTERPRISES, INC., dba BONZA TUCKER, a California Corporation,	**ORDER DENYING PETITIONS FOR REHEARING & EN BANC SUGGESTIONS**
Appellees.	

Before: ALDISERT*, TANG and FLETCHER, Circuit Judges.

The panel as constituted above has voted to deny the petitions for rehearing and to reject the suggestions for rehearing en banc.

The full court has been advised of the suggestions for rehearing en banc, and no judge of the court has requested a vote on the suggestions for rehearing en banc. Fed. R. App. P. 35(b).

The petitions for rehearing are denied and the suggestions for rehearing en banc are rejected.

---

* Honorable Ruggero J. Aldisert, Senior Judge, United States Court of Appeals for the Third Circuit, sitting by designation.

APPENDIX V

STATUTE INVOLVED

The principal statute involved is Federal Rule of Civil Procedure 23.1.

Rule 23.1 Derivative Actions by Shareholders

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it

would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the plaintiff's failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or comprised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

Supreme Court, U.S.
FILED
NOV 20 1990
JOSEPH F. SPANIOL, JR.
CLERK

(2)

No. 90-530

In The

Supreme Court of the United States

October Term, 1990

ROUND TABLE PIZZA, INC., et al.,

Petitioners,

vs.

WILLIAM R. LARSON,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTION PRESENTED

Should this Court grant review to consider whether a single court of appeals panel misanalyzed the record and based its decision on an allegedly incorrect factual ground although the legal grounds were correct? While petitioner complains that the Court of Appeals misapplied the abuse of discretion standard of review, there is no dispute over the propriety of the standard the Court stated it was applying. Rather, petitioner complains only that the Court applied the correct standard in an incorrect way in this particular case.

LIST OF PARTIES

The parties to the proceedings below were Richard A. Dumke, Scott O. Bergren, Norman E. Dean, Frederick L. Doar, Paul J. Miller, Robert C. Scheidemann, Charles A. McPhee, Jr., Anne W. Barron, George P. Kailis, Round Table Pizza, Inc., a California corporation, Hills Bros. Coffee, Inc., a Delaware corporation, Aussie's Enterprises, Inc., dba Bonza Tucker, a California corporation, and respondent William R. Larson.

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No. 90-530

In The

Supreme Court of the United States

October Term, 1990

ROUND TABLE PIZZA, INC., et al.,

Petitioners,

vs.

WILLIAM R. LARSON,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

OPINIONS BELOW

The opinion of the Court of Appeals for the Ninth Circuit is reported at 900 F.2d 1363 and is reprinted in Appendix I of petitioner's petition. (A-1-31) The memorandum decisions and orders of the United States District Court for the Northern District of California (CR 291 & 344) have not been reported. They are reprinted in Appendices II and III of petitioner's petition. (A-40-51)

JURISDICTION

The district court had subject matter jurisdiction pursuant to 28 U.S.C. Section 1331, and dismissed Mr. Larson's derivative claims, ruling that he did not fairly and adequately represent similarly situated shareholders under Fed. R. Civ. P. 23.1 (hereafter Rule 23.1 or the Rule). The district court certified the matter for appeal under Fed. R. Civ. P. 54(b), and Mr. Larson filed a timely appeal with the Ninth Circuit. On April 9, 1990, that Court reversed the judgment of dismissal and reinstated the derivative claims. Round Table filed a petition for rehearing and rehearing *en banc* on April 24, 1990, which was denied on June 25, 1990. (A-52-53) Round Table filed a timely petition for writ of certiorari on September 24, 1990, and invokes this Court's jurisdiction under 28 U.S.C. Section 1254(1).

STATUTE INVOLVED

The statute involved is Federal Rule of Civil Procedure 23.1, which provides in pertinent part:

> In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law, and (2) that the action is not a collusive one to

> confer jurisdiction on a court of the United States which it would not otherwise have. . . . The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association . . . . (*See*, Petn. at A-54-55 for complete text of Rule 23.1)

REASONS FOR DENYING THE WRIT

The Court of Appeals held that a single, substantial shareholder like Mr. Larson may pursue the derivative claims on behalf of the corporation, notwithstanding opposition to the lawsuit by the non-defendant shareholders. The Court reasoned that because those shareholders believed they stood to lose financially from the lawsuit, Mr. Larson was not "similarly situated" to them. It also held that Mr. Larson met the "fair and adequate representation" requirement of Rule 23.1 and that he was not disqualified from serving as a proper derivative plaintiff because of any "economic antagonism."

The effect of the Court of Appeals' opinion is to give Mr. Larson his day in court, by granting him standing to pursue the derivative claims against the errant directors and officers for their egregious misconduct over the past decade. Not only is that result consistent with the judicial policy that cases should be disposed of on their merits, but the Court's opinion represents a correct application of the principles governing "adequacy of representation" issues under Rule 23.1.

Nevertheless, Round Table, a nominal defendant that is controlled by the very individuals who are alleged to have engaged in wrongdoing, has decided to pursue the matter in this Court, asserting that the Court is "mandated" to exercise certiorari jurisdiction. Its petition proceeds from three erroneous or misleading premises:

> First, it assumes that this Court's supervisory powers should be exercised to correct an asserted error of a Court of Appeals panel when that error is at most based only on a misreading of the facts in the record which are unique to this case and have no application to other cases.
>
> Second, it assumes that this Court should grant certiorari to correct a Court of Appeals' alleged misapplication of the "abuse of discretion" standard of review, when the Court's opinion, if fairly read, demonstrates that the Court fully understood that standard, gave deference to the district court where appropriate, and properly reversed for *both* an error of law and a "clearly erroneous" factual finding.
>
> Finally, it contends that certiorari should be granted because the Court of Appeals' analysis was wrong on two issues, but nowhere does it challenge – indeed, it does not even mention – that there was a third aspect to the Court's opinion that is unquestionably a valid basis for its holding under governing legal principles.

Once these three misperceptions are corrected and the Court of Appeals' opinion fairly analyzed, it is apparent that there is no reason for adding this case to an already overburdened Supreme Court docket.

STATEMENT OF THE CASE

William R. Larson is the founder of Round Table Pizza. In 1978, he sold a 75 percent interest in the company to Richard Dumke and his associates ("the Dumke group"). For approximately ten years following the sale, the Dumke group repeatedly placed their personal and financial interests above Round Table's, and engaged in speculative business ventures and self-interested transactions that deprived the company of millions of dollars. (CR 149 at ¶¶ 29-31, 91)[1] The Dumke group also: (1) consistently misrepresented important facts and concealed information from shareholders, other directors, and financial institutions; (2) withheld information from Mr. Larson and his representatives by denying them access to corporate records and removing documents from files to which he was given access; and (3) forged records to cover up their acts. (CR 149 at ¶ 88)

Specifically, the Dumke group:

> – Secretly profited by causing Round Table to acquire Far West Pizza, Inc., a financially strapped pizza company which the Dumke group owned, through an exchange of Round Table shares for Far West shares, by grossly inflating the value of Far West stock, concealing the nature and extent of Far West's liabilities,

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[1] The facts recited here are taken from the allegations of the First Amended Complaint (CR 149), which, at this preliminary point in the litigation and for purposes of finally determining the motion to dismiss, must be deemed true. *Gaines v. Haughton*, 645 F.2d 761, 770 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982), *citing*, *De La Cruz v. Tormey*, 582 F.2d 45, 48 (9th Cir. 1978), *cert. denied*, 441 U.S. 965 (1979); *Rogers v. American Can Company*, 305 F.2d 297, 318 (3d Cir. 1962)

and misrepresenting Far West's profitability. (CR 149 at ¶¶ 58-60, CR 263 at 13, n. 11);

– Secretly benefitted by manipulating the acquisition of Aussie's, a chicken restaurant franchise, such that (1) Round Table paid for a purported 50 percent control of the company but received only 42 percent, with the remaining 8 percent going to Dumke group member Scott Bergren, (2) Round Table was forced to guarantee 100 percent of an Aussie's debt despite its minority interest in the company; (3) additional stock was issued to Dumke group members after the initial offering, thereby diluting Round Table's interest to below 10 percent, and (4) when Aussie's proved to be a bad investment, caused Round Table to purchase back the Dumke group members' stock at the original selling price (despite its substantial decrease in value), all to Round Table's severe prejudice (CR 149 at ¶¶ 62-77, 95-98, 107-108);

– Usurped Round Table's corporate opportunity in acquiring Buffalo Chips, a gourmet potato chip company, by secretly acquiring the company, then rescinding the acquisition a few months later for a better investment opportunity and embroiling Round Table in costly litigation when Buffalo Chips sued the Dumke group and Round Table concerning the rescission (CR 149 at ¶¶ 39-55, 105); and

– Induced Round Table to establish, through misrepresentations and inaccuracies as to the company's expected performance and worth, an Employee Stock Option Plan that overburdened the company with debt and loan obligations that it could ill afford, all for the purpose of paying themselves nearly $9 million (CR 149 at ¶¶ 33-38, CR 105, Exhs. A-C, F-H).

As a result of the foregoing conduct and other wrongful action by which the Dumke group profited (CR 149 at ¶¶ 29, 88-92), in the approximately ten years following the sale, Round Table did not experience anywhere near the $6 million to $8 million profit expected of a successful franchise operation of this size, and paid no dividends to its shareholders. (*Id.* at ¶¶ 29-30, 91)

Faced with these improprieties, Mr. Larson brought suit in 1987 against the Dumke group and others, alleging both derivative and individual claims based on violations of federal and state securities laws, RICO, fraud, breach of fiduciary duty, and other common law theories. (CR 1)[2] Before any substantial discovery could be conducted, however, defendants moved to dismiss the derivative counts on the ground that Mr. Larson was an inadequate representative under Rule 23.1, and argued that he could not fairly represent the interests of other "similarly situated" (*i.e.*, "minority") shareholders, who collectively hold only 9.3 of the outstanding stock (or approximately one-third of what Mr. Larson owns individually). (CR 217-234, 245, 255)[3]

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[2] Round Table's claim that "[t]he ESOP transaction was at the center of Larson's motivation for bringing this action" (Petn. at 13) is incorrect. (*See*, Reply Brief of Mr. Larson at 2-3)

[3] In fact, the shareholders who are not associated with the Dumke group represent an even smaller portion of the outstanding stock. As the Court of Appeals observed, of the stock owned by individual non-defendants other than Mr. Larson, Thomas Toldrian, Round Table's Chief Financial Officer and a director at the time of the alleged wrongdoing, owns 7.7 percent and the remaining shareholders hold only 1.6 percent. (A-26)

In support of their dismissal motion, defendants submitted declarations they had prepared on behalf of these shareholders following meetings with them. (*See*, CR 321, Exh. E at 46:7-10, 47:2-4) The declarations alleged, in generally identical boilerplate paragraphs, that these shareholders opposed the lawsuit and supported current management. (*E.g.*, CR 221 at 3-4, CR 222 at 3-5, CR 223 at 3-4).[4]

The district court agreed with Round Table and dismissed the derivative claims. (CR 291 at 2 (A-35-37), (CR 344 (A-40-47)) It found that in order for a derivative plaintiff to meet the "adequacy of representation" requirement of Rule 23.1, he or she must fairly represent a "class" consisting of the other "minority shareholders" – here, "all minority shareholders as of the time of the formation of the ESOP." (CR 344 at 3-4 (A-44)) Because those shareholders "universally oppose[d]" the lawsuit, the court found, Mr. Larson could not fairly and adequately represent their interests. (*Id.* at 4 (A-44)) The

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[4] One of the shareholders, Gennaro Filice, revealed in his deposition that he really didn't "know anything," had "no knowledge of what's going on," and didn't "want to have anymore [*sic*] knowledge of what's going on" (*id.* at 71:23-25) concerning the lawsuit. He admitted that Round Table's lawyers (who were retained by the defendant wrongdoers) told him that the lawsuit was too expensive for the corporation and would "damage" it. (CR 321, Exh. E at 23:2-4, 65:20-23) Counsel also told him that if there had been any wrongdoing, Mr. Larson's individual claims would "take care" of it without the corporation incurring the expense of a lawsuit. (*Id.* at 50:9-13) However, counsel omitted to tell Mr. Filice that any recovery on the derivative claims would go to Round Table, not Mr. Larson. (*Id.* at 26:15-20)

court further reasoned that there was "economic antagonism" between Mr. Larson and the other minority shareholders because those shareholders would be required to return funds received from the sale of their shares to the ESOP, and "antagonism" between Mr. Larson and the corporation, which the district court found would be "harmed" by the ESOP's rescission. (*Id.* at 4-5 (A-45-46))[5]

On appeal, Mr. Larson argued that the district court had abused its discretion because it *both* misperceived or erroneously resolved factual issues *and* erroneously interpreted the "fair and adequate representation" requirement in Rule 23.1 as a matter of law. A substantial shareholder like Mr. Larson, even though opposed by all of the remaining non-defendant shareholders, may nevertheless be an adequate derivative representative under Rule 23.1. The Rule nowhere requires the derivative plaintiff to be "similarly situated" to any other shareholders, nor does it define "similarly situated" shareholders as the "class" of all "minority shareholders," as the district court had ruled. As long as the plaintiff adequately represents the interests of the *corporation* in whose name he sues derivatively, the "fair and adequate representation" requirement of Rule 23.1 is fulfilled. Finally, even if the Rule requires some harmony of

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[5] The district court rejected defendants' claim that Mr. Larson should have made a demand on the directors to bring suit on behalf of the corporation, and found that a demand would have been "futile in this context, where the allegations are that the director defendants participated in the wrongdoing, and in particular, in self-interested transactions." (CR 291 at 2, CR 286, *see*, CR 186-187, 189, 206-207, 209-214, 247-248)

interest between shareholders who are "similarly situated," here because *all* of the remaining shareholders – defendants and non-defendants alike – benefited from defendants' illegal conduct, Mr. Larson is not "similarly situated" to them and he cannot be deprived of derivative standing on that basis.

The Court of Appeals agreed with many of Mr. Larson's arguments, and found that the district court had abused its discretion in at least three distinct ways:

> A. The Court held that Mr. Larson had not made a "formal" or "meaningful" – *i.e.*, proper – demand for rescission of the ESOP, so his "request for money damages resulting from alleged improprieties in establishment of the ESOP" did not "in and of itself make [him] an inadequate representative." (900 F.2d at 1364, 1367-1368)
>
> B. Relying on well-established authority that "a single shareholder may bring a derivative suit" [*id.* at 1368], the Court held that "lack of support for the derivative suit by nondefendant shareholders" is not a factor sufficient to support the district court's exercise of discretion." While the "degree of support a putative plaintiff receives from other shareholders . . . is a factor that should be considered in determining adequacy of representation," here each "non-defendant shareholder . . . has an economic interest in supporting the current management" and thus, "the lack of support for the derivative suit, in and of itself, does not indicate that Larson is an inadequate representative." (*Id.* at 1368-1369) Accordingly, "Larson is the only shareholder

similarly situated and . . . meets the Rule 23.1 qualifications." (*Id.* at 1369)[6]

C. The Court rejected defendants' claim that Mr. Larson's offer to sell his shares to Round Table at prices ranging between $14.75 and $18.75 per share – in excess of the $9.78 per share price that the ESOP paid – proved that the derivative action was a "strike suit" designed to obtain a premium price for his shares. (*Id.* at 1369) The record demonstrated that the high price offering was Mr. Larson's attempt to free his shares from a right-of-first-refusal requirement that the Dumke defendants caused Round Table to enact. (*See*, CR 319 at 1-3, & Exh. D, CR 320, Exh. B, CR 321 at 2-3 & Exh. A, CR 330 at 16, n. 12)

On the basis of the foregoing, the Court concluded:

"that Larson is the true party in interest, that he is familiar with this litigation, that he has a personal commitment to this action, that the remedy sought can be construed as legitimate for the corporation, that Larson's interest in his personal claims do not outweigh his interest in those asserted on behalf of the corporation, and that notwithstanding the possibility of personal vindictiveness or animosity between Larson and the defendants, it has not been established that

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[6] Unfortunately, Round Table's transcription of the Court of Appeal's opinion contains a significant typographical error. On A-27, it quotes the Court of Appeals as stating: "We have concluded that the lack of support for the derivative suit, in and of itself, does not indicate that Larson is an *adequate* representative." (Emphasis added) In fact, the Court of Appeals' opinion states: "We have concluded that the lack of support for the derivative suit, in and of itself, does not indicate that Larson is an *inadequate* representative." (900 F.2d at 1369, emphasis added)

> Larson is an inadequate representative for the derivative claims." (*Id.* at 1369)

Instead of acknowledging that the second ground ("B" above) was a basis for the Court of Appeal's decision, Round Table pretends it does not exist, and focuses its attack solely on the ESOP rescission and "strike suit" issues. On those issues, it insists that because the Court of Appeals made a "far departure" from the accepted course of judicial proceedings and created a "conflict among the circuits" as to the application of the abuse of discretion review standard in Rule 23.1 cases, this Court is "mandated" to grant certiorari. (Petn. at 27-30) Not only are these claims seriously flawed, but the one aspect of the Court of Appeals' opinion that petitioner carefully avoids, proves that the Court reached the right result for the right reason. Accordingly, the petition should be denied.

ARGUMENT

A. The Court of Appeals Properly Held That A Single Shareholder In Mr. Larson's Position May Maintain A Derivative Action

Derivative suits were developed out of a recognition that the corporate structure accords management "almost uncontrolled discretion in handling other people's money." *Cohen v. Beneficial Industrial Loan Corp.*, 331 U.S. 541, 547 (1949). Because directors are able to amass considerable power and abuse the discretion entrusted to them, the courts have held that equity permits shareholders to act to protect the corporation's interest. *Koster v. Lumbermens Mutual Cas. Co.*, 330 U.S. 518, 552-553

(1947); *see, Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530 (1984).

The derivative plaintiff in such an action acts as management's conscience, to ensure that the corporation follows prescribed guidelines, adheres to its rules, and refrains from engaging in illegal or self-interested transactions. *See generally*, 2 Marsh's Calif. Corporation Law § 14.28 (1988 Supp.). At the same time, because the derivative plaintiff acts as a "corporate surrogate seeking vindication of a corporate right" [*Sweet v. Bermingham*, 65 F.R.D. 551, 553 (S.D.N.Y. 1975)] and the corporation is bound by the result of the suit [*Ross v. Bernhard*, 396 U.S. 531, 538-539 (1970)], the plaintiff must meet certain requirements before the derivative action can proceed.

The "adequacy of representation" element is one such requirement, and seeks to ensure that *if* the derivative plaintiff purports to speak for other similarly situated shareholders, he or she must fairly and adequately represent their interests in seeking redress on the corporation's behalf. Advis. Comm. on Civil Rules, Comment to Rule 23.1; *see*, Cohn, "The New Federal Rules of Civil Procedure," 54 *Geo. L.J.* 1204, 1227 (1966).[7] This element is

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[7] There are other requirements the derivative plaintiff must meet: (1) the plaintiff must have been a shareholder at the time of the challenged transaction or must have acquired shares of other aggrieved shareholders by operation of law; (2) the action must not be a collusive one to confer jurisdiction on a federal court; (3) the plaintiff must make a demand on the directors as a prerequisite to proceeding with the lawsuit, which demand is excused if it would be futile; and (4) if the action is permitted to proceed, the plaintiff may not dismiss or settle the lawsuit without the approval of the court and notice to the shareholders. Rule 23.1.

embodied in Rule 23.1's requirement that "[t]he derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association."

This requirement applies only when the derivative plaintiff purports to represent the interests of "similarly situated" shareholders.[8] As Professors Moore and Kennedy have noted, the "similarly situated" language of Rule 23.1 "must necessarily refer to a minority or other definable group of shareholders *with interests similar to the*

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[8] Where there are *no* "similarly situated" shareholders, however, a derivative plaintiff may nevertheless be disqualified from maintaining the action where he or she has interests antagonistic to the corporation in enforcing its rights. *See, Sweet v. Bermingham, supra,* 65 F.R.D. at 554; *Fradkin v. Ernst,* 98 F.R.D. 478, 484 (N.D. Ohio 1983). However, only "antagonism" that "goes to the subject matter of the suit" – *i.e.*, that demonstrates that the interests of the corporation will be disregarded if the derivative action is maintained – will deprive a derivative plaintiff of standing. *G.A. Enterprises, Inc. v. Leisure Living Commun., Inc.,* 517 F.2d 24, 27 (1st Cir. 1975). Such "antagonism" is generally exemplified by competing business interests, such as competition between the corporation and an entity in which the plaintiff has a personal interest, or by the plaintiff's interest in personal gain which overshadows any corporate interests sought to be furthered by the derivative suit. *E.g., Robinson v. Computer Servicenters, Inc.,* 75 F.R.D. 637, 641-643 (N.D. Ala. 1976); *Davis v. Comed,* 619 F.2d 588, 594-595 (6th Cir. 1980), *Baron v. Strawbridge & Clothier,* 646 F.Supp. 690, 695-696 (E.D. Pa. 1986). Round Table addresses only one such alleged "antagonism" in its petition, which Mr. Larson discusses *infra,* at pp. 22-24.

plaintiff because otherwise a derivative suit would be logically impossible whenever the interest of the majority of the stockholders coincided with the defendants." 3B Moore & J. Kennedy, *Moore's Federal Practice*, ¶ 23.1.16[3] at 23.1-59 (2d ed. 1979) (fns. omitted, emphasis added). Indeed, the most often quoted opinion on the subject of Rule 23.1 adequacy of representation, *Davis v. Comed, Inc., supra*, 619 F.2d 588, states that among the factors the courts should consider in determining adequacy of representation is "the degree of support plaintiff was receiving from the shareholders *he purported to represent*." *Id.* at 594 (emphasis added).

Accordingly, the courts have properly held that a single shareholder may maintain a derivative action, notwithstanding the support of or opposition by a "class" of other shareholders. *See, Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363, 371 (1966) (single shareholder owning 0.06 percent of corporation's shares held to be adequate representative); *Lewis v. Curtis*, 671 F.2d 779, 788-789 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982) (single shareholder owning 100 of 8 million shares held to be adequate representative); *Shulman v. Ritzenberg*, 47 F.R.D. 202, 211 (D.D.C. 1969) (single shareholder opposed by 47 of company's 53 shareholders found adequate representative); *see also, Ohio-Sealy Mattress Mfg. Co. v. Kaplan*, 90 F.R.D. 21, 27 (N.D. Ill. 1980) (permitting derivative action by shareholders owning 0.07 percent of stock, even though opposed by "vast majority of shareholders" who collectively owned 90 percent). Other courts have held that the derivative plaintiff need *not* represent "similarly situated" shareholders in order to maintain the action. *Shulman v. Ritzenberg, supra*, 47 F.R.D. at 211; *Halsted Video,*

Inc. v. Guttillo, 115 F.R.D. 177, 180 (N.D. Ill. 1987); *F.D.I.C. v. Kerr*, 650 F.Supp. 1356, 1358-1359 (W.D.N.C. 1986); *but see, Kuzmickey v. Dunmore Corp.*, 420 F.Supp. 226, 230-231 (E.D. Pa. 1976).

The Court of Appeals properly applied these principles in its opinion here. It concluded that, contrary to the district court (CR 344 at 3 (A-44)), Mr. Larson was not required to represent the interests of the "class" of other minority (*i.e.*, nondefendant) shareholders in order to maintain the derivative claims. (A-24-25) It further held that because each of the other non-defendant shareholders benefited from the ESOP's formation and may have been confused and misled as to the consequences of Mr. Larson's potential success on that claim, their opposition to the lawsuit may have been motivated by "individual interests, rather than the good of the corporation." (A-27) Accordingly, their opposition was not determinative of Mr. Larson's ability to serve as a fair and adequate derivative representative because they were not "similarly situated" to him. (*Id.*) This was the precise issue which divided the parties sharply both in the district court and on appeal.

In its petition here, Round Table meticulously ignores this aspect of the Court of Appeals' opinion. Yet, the Court's analysis of the "single shareholder" issue was an adequate basis for reversing the district court's judgment. It was also indisputably a correct interpretation of the Rule 23.1 fair representation requirement that is fully consistent with existing case law. On this basis alone, then, the Court of Appeals reached the correct result on sound reasoning and there is no reason for this Court to intervene.

B. Round Table's Claim That This Court's Certiorari Jurisdiction Is "Mandated" Does Not Withstand Analysis

Round Table asserts that this Court is "mandated" to grant certiorari because the Court of Appeals (1) failed to apply the abuse of discretion standard properly, "thereby rendering a decision 'in conflict with decision[s]' of all other federal Courts regarding the proper standard of review" of adequacy of representation claims under Rule 23.1, and (2) rendered a decision that represented a "far departure" from the "accepted and usual course of judicial proceedings. . . . " (Petn. at 27-30, 34, *citing*, Supr. Ct. Rule 10.1(a)) These claims do not withstand scrutiny.[9]

Round Table's contention is only that the Court of Appeals misanalyzed the record and reached an aberrant result in a single case on unique facts.[10] This is hardly

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[9] As a preliminary matter, it is manifest that certiorari jurisdiction is never "mandated." Supreme Court Rule 10.1 itself provides that "[a] review on writ of certiorari is not a matter of right, but of judicial discretion," and that the writ will be granted "only when there are special and important reasons therefor." The "reasons" specified in Rule 10.1 – which include a conflict among the circuits and a "far departure" from the "accepted and usual course of judicial proceedings" – are not determinative of this Court's jurisdiction. As Rule 10.1 states, the reasons listed are "neither controlling nor fully measuring the Court's discretion," but merely "indicate the character of reasons that will be considered" in determining whether this Court should grant review. Round Table's claim that this Court must grant certiorari if any of the Rule 10.1 factors are present simply misreads the rule.

[10] This argument, of course, erroneously ignores the Court's "single shareholder" analysis discussed above, that is an alternate and independent basis for permitting Mr. Larson to pursue the merits of the derivative claims.

sufficient, because the correctness of a lower court decision is rarely if ever grounds for granting certiorari. As Justice Rehnquist wrote in *Ross v. Moffitt*, 417 U.S. 600, 616-617 (1974), "[t]his Court's review . . . is discretionary and depends on numerous factors other than the perceived correctness of the judgment we are asked to review." To grant certiorari here and in other like circumstances would effectively convert this Court into one of error rather than one whose role is to ensure consistency among the Courts of Appeal and pass on important federal questions of the day.

Moreover, neither of the two Rule 10.1 reasons on which Round Table relies – a purported misapplication of the abuse of discretion standard of review that allegedly creates an inter-circuit conflict or an asserted "far departure" from the "accepted and usual course of judicial proceedings" on the ESOP rescission issue – is present here. The Court of Appeals correctly applied the abuse of discretion test on both legal and factual matters and reached the proper result on the ESOP rescission issue.

1. The Court of Appeals Correctly Applied The Abuse Of Discretion Standard

All parties here agree that the abuse of discretion standard applies in reviewing a district court's determination of adequacy of representation issues under Rule 23.1. *Owen v. Modern Diversified Industries, Inc.*, 643 F.2d 441, 443 (6th Cir. 1981); *Hornreich v. Plant Industries, Inc.*, 535 F.2d 550, 552 (9th Cir. 1976); *Lewis v. Curtis, supra*, 671

F.2d at 789; *Rothenberg v. Security Management Co., Inc.*, 667 F.2d 958, 960, 963 (11th Cir. 1982).

The abuse of discretion test has two distinct components – factual and legal. Which component applies depends on the nature of the appellant's contention. Thus, if the appellant claims that the district court erroneously resolved *factual* questions, the reviewing court will reverse if the district court's factual findings are "clearly erroneous" – *i.e.*, when " 'the reviewing court on the entire evidence is "left with the definite and firm conviction that a mistake has been committed." ' " *Anderson v. Bessemer City*, 470 U.S. 564, 573 (1985), *quoting*, *United States v. United States Gypsum Co.*, 333 U.S. 364, 395 (1948); *accord*, *Dollar Rent A Car of Washington v. Travelers Indem.*, 774 F.2d 1371, 1374 (9th Cir. 1985); *Edinburgh Assur. Co. v. R.L. Burns Corp.*, 669 F.2d 1259, 1261 (9th Cir. 1982); *Owen v. Modern Diversified Industries, Inc.*, *supra*, 643 F.2d at 443[11]

Where a pure *legal* question is involved, however, the abuse of discretion test mandates reversal where the lower court's order was based on or influenced by an erroneous legal premise. *FSLIC v. Sahni*, 868 F.2d 1096,

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[11] Thus, in *Matter of Beverly Hills Bancorp*, 649 F.2d 1329, 1333-1334 (9th Cir. 1981), this Court held that the district court had erred in reforming a contract on the basis of mutual mistake, because neither party had requested reformation or revision, but instead had merely sought interpretation of the contract as written. Because there was nothing in the record to support the conclusion that the contract between the parties failed to express their mutual intention, the Court of Appeals was left with a " 'definite and firm conviction that a mistake had been committed.' " *Id.* at 1334.

1097 (9th Cir. 1989); *Heat and Control, Inc. v. Hester Industries, Inc.*, 785 F.2d 1017, 1022 (Fed. Cir. 1986) (and cases cited). Stated differently, "[a] district court's order is reversible for legal error if, in applying the appropriate standards, the court misapprehends the law with respect to the underlying issues in the litigation. [Citation.]" *Dollar Rent A Car of Washington v. Travelers Indem., supra,* 774 F.2d at 13. An abuse of discretion will be found where, in light of the "relevant factors," there was a "clear error in judgment. . . . " *Id.; accord, Kern v. TXO Production Corp.*, 738 F.2d 968, 970 (8th Cir. 1984) "[abuse of discretion] means . . . that the court has a range of choice, and that its decision will not be disturbed as long as it stays within that range and is not influenced by any mistake of law"). In such cases, the legal issues are reviewed *de novo* by the reviewing court. *FSLIC v. Sahni, supra,* 868 F.2d at 1097.[12]

The Court of Appeals based its reversal in part on this second component of the abuse of discretion test. The Court held that the district court erred as a matter of law

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[12] Thus, in *Lewis v. Curtis, supra,* 671 F.2d 779, the Court of Appeals reversed the district court's finding of inadequate representation, holding that it had erred as a matter of law – and consequently had abused its discretion – in disqualifying the plaintiff because he owned only 100 of the corporation's 8 million shares. The Court found "no basis for dismissing [the plaintiff's] complaint simply because he only owns a few shares of . . . stock." *Id.* at 788. The Court also rejected the directors' claim, again as a matter of law, that the plaintiff's ignorance as to the facts concerning the challenged transactions renders the plaintiff an inadequate representative, stating: "[w]e do not believe that [familiarity with the facts] makes vigorous representation of the class any more likely." *Id.* at 789.

when it required Mr. Larson to be a member of a "class" of minority shareholders, whose views concerning the action were determinative of the standing question. This holding is obvious from the Court of Appeal's conclusion that Mr. Larson was not similarly situated to the other shareholders because each of them is "presently or have been employees of Round Table" and each "has an economic interest in supporting the current management: the Dumke group." (A-26)

Once again, Round Table does not mention this aspect of the Court of Appeals' opinion. Yet, it is an independent basis for reversal, and does not depend on the outcome of the ESOP rescission and/or strike suit issues. Most importantly, because it represents a correct application of the legal component of the abuse of discretion test, it creates no inter-circuit conflict for this Court to resolve, and certiorari is inappropriate.

Even on the ESOP rescission and strike suit issues, to which the Court of Appeals applied the factual component of the abuse of discretion test, the Court did not err in concluding "on the entire evidence" that " 'a mistake [had] been committed.' " *Dollar Rent A Car of Washington v. Travelers Indem., supra,* 774 F.2d at 1374. On the ESOP rescission issue, as the record and oral argument confirmed, Mr. Larson did not make a "meaningful" (A-22) demand – "formally" (A-7) or otherwise – to rescind the ESOP, nor did the district court ever permit him to seek a rescissionary remedy. Rescission was not pled in either the original or the first amended complaint (CR 1, 149), and none of Mr. Larson's fellow minority shareholders

were ever joined as defendants. (A-22)[13] Thus, while Mr. Larson's trial counsel discussed rescission in opposing Round Table's motion to dismiss, and Mr. Larson at one point did withdraw his "offer" *not* to seek rescission (when all of the remaining shareholders failed to abandon their opposition to the lawsuit) (CR 319 at ¶ 9), the Court of Appeals could properly conclude that this discussion was irrelevant because rescission had never been properly sought in the first place.[14] The district court's conclusion to the contrary was therefore "clearly erroneous" and the Court of Appeals' reversal for abuse of discretion was correct.

The Court of Appeals also properly reversed for abuse of discretion on the "strike suit" issue. The district court had before it two explanations for Mr. Larson's offer to sell stock to Round Table at higher-than-ESOP prices: (1) Mr. Larson's detailed explanation – accompanied by documentary evidence – that his offer was an attempt to free his shares from Round Table's right-of-first-refusal requirement and to ensure the transferability of those shares to buyers other than Dumke group members (CR 257 at 2, CR 319 at 1-4, CR 320, Exh. B, CR 321, Exh. A, CR 330 at 16, n. 12); and (2) the declaration from

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[13] The district court denied Mr. Larson's motion to amend his complaint to add those shareholders as defendants so that the court would be in a position to permit rescission – a motion made between the district court's first and second orders – as an exercise in futility because the derivative claims had been dismissed. (A-47-49)

[14] Mr. Larson was represented in the district court by the firm of Brobeck, Phleger & Harrison. On appeal, present counsel substituted in.

Thomas Toldrian, Round Table's Chief Financial Officer and a director at the time of the alleged misconduct [*see*, A-26], who stated that Mr. Larson told him "that his motivation in bringing this action is to achieve the sale of his own Round Table stock at a premium price" (CR 232 at 4).

Mr. Larson steadfastly denied that the lawsuit was a ploy to achieve a higher price for his shares. (CR 257 at 2, CR 319 at 4) Nevertheless, in its first order, the district court found that "economic antagonism" existed between Mr. Larson and the other shareholders because of, *inter alia*, "the higher price plaintiff has attempted to obtain for his stock." (CR 291 at 3, (A-36)) However, *after* Mr. Larson offered his explanation for the stock sale proposal, the district court on reconsideration apparently abandoned that ground as a basis for finding that Mr. Larson was an inadequate representative. (*Compare*, CR 291 at 3 (A-36) *with* CR 344 at 4-5 (A-46))

It was in this posture that the issue was presented to the Court of Appeals. That Court found that Mr. Larson's version of the facts was "consistent with communications with Round Table management at the time of the offering." (A-28) Indeed, in the district court Round Table had attacked Mr. Larson's explanation as "nonsensical" (CR 338 at 9), but it *never* denied that the steps he took *would* free up his shares for sale to others.[15] In light of the

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[15] In any event, the notion that Mr. Larson could legally sell his shares to Round Table at a higher price or on terms not available to every other shareholder is erroneous. *See, Jones v. H.F. Ahmanson & Co.*, 1 Cal.3d 93, 108-111 (1969). Since Mr.

(Continued on following page)

timing of the stock sale offer (after the right-of-first-refusal requirement was instituted), the district court's abandonment of the "strike suit" ground in its second order, Mr. Toldrian's status as a potential wrongdoer, and the documentary evidence Mr. Larson offered as compared to the hearsay statement Mr. Toldrian attributed to him, the Court of Appeals was entitled to reject the district court's earlier "strike suit" finding as mistaken and to permit Mr. Larson to proceed with the merits of his action. *Matter of Beverly Hills Bancorp, supra,* 649 F.2d at 1334.

2. The Court of Appeals' Decision Was Not A "Departure," Much Less A "Far Departure" From Accepted Judicial Decisions

Finally, Round Table claims that certiorari is mandated because the Court of Appeals decision represents a "far departure" from accepted judicial decisions. (Petn. at 27-28, Supreme Ct. Rule 10.1(a) It bases this claim on the Court of Appeal's analysis of the ESOP rescission issue and that Court's failure to rectify the error by a grant of rehearing. (*Id.* at 28-30) As noted above, the Court properly analyzed the ESOP rescission issue and reached the

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(Continued from previous page)

Larson was closely and continuously counselled by his lawyers, pressing the derivative lawsuit to obtain an illegal result would have meant that his lawyers were in essence attempting to engage in unlawful conduct. The Court of Appeals' resolution of the issue demonstrates that even it was unwilling to indulge in this reasoning. This is a further reason why Mr. Larson's explanation for the stock sale offer was the only credible version.

correct result based on the pleadings and the district court's denial of the motion to amend. Any suggestion that the Court of Appeals departed (a little or a lot) from the "accepted and usual course" of judicial proceedings is without merit.[16]

CONCLUSION

The Court of Appeals reviewed the district court's ruling through the appropriate abuse of discretion lens of appellate review and correctly concluded that that court's view of Rule 23.1 – that opposition by the non-defendant shareholders necessarily renders a derivative plaintiff an inadequate derivative representative – was flawed as a matter of law. The court properly applied the factors the Sixth Circuit articulated in *Davis v. Comed*, found that the other non-defendant shareholders were not "similarly situated" to Mr. Larson and held that he was therefore an adequate derivative representative. This was not even a "departure" (much less a "far departure") from existing precedent, represented a correct application of the "abuse of discretion" standard of review, and was consistent with other decisions under the adequacy of representation element of Rule 23.1. There is nothing novel or

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[16] It is not surprising that Round Table cites no authority for its claim that the Court of Appeals acted improperly by "conducting its own 'painstaking study of the trial record' " on an issue not raised by the parties. (Petn. at 29) Of course, as section IV.B. of its opinion demonstrates, the Court *also* based its opinion on the "single shareholder" argument that Mr. Larson urged.

important, let alone erroneous, about the Ninth Circuit's opinion, and certainly no reason why this Court should intervene. Accordingly, the petition should be denied.

DATED: November 19, 1990

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No. 90-530

In The

Supreme Court of the United States

October Term, 1990

ROUND TABLE PIZZA, INC., ET AL.,

Petitioners,

v.

WILLIAM R. LARSON,

Respondent

REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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Only one paragraph of Larson's Opposition addresses the main issue raised for this Court's review: whether, by conducting an independent and painstaking review of the record to reverse the trial court's factual finding that Larson sought recision of the ESOP, the Court of Appeals both misapplied the abuse of discretion standard and departed from the accepted and usual course of judicial proceedings.

Instead of responding to this asserted error, Larson rewrites the Court of Appeals' holding, and then attempts to justify the result of the revised opinion. At best, Larson's transparent revision of the Court of Appeals' decision is misguided; at worst, it is a blatant attempt to obfuscate the issues properly presented in Round Table's Petition.

The Court of Appeals' reversal was based on its finding that the factual predicates of the trial court's decision had no support in the record. The panel stated that the issue of whether Larson satisfied the adequacy of representation requirement under Rule 23.1 essentially turned on a single issue: "whether, as found by the trial court, [Larson] sought to rescind" the ESOP.[1] After conducting a "painstaking study of the trial court record," the panel incorrectly found that Larson was not seeking recision of the ESOP.[2] Thus, because it believed "the major factual predicate of the trial court's decision finds

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[1] Appendix I at A-7.

[2] Id.; see also Appendix I at A-21-23.

no support in the record," the Court of Appeals reversed.[3] By conducting an independent and painstaking review of the record to reverse a factual determination, the Court of Appeals misapplied the abuse of discretion standard and deviated from the accepted and usual course of judicial proceedings.[4] Round Table's Petition requests that this Court grant certiorari to correct the Court of Appeals' errors.

Larson's Opposition, however, virtually ignores the Court of Appeals' express rationale and the arguments raised in Round Table's Petition. Instead, Larson argues that the panel reversed to correct the trial court's flawed conclusion of law. Larson claims that the Court of Appeals reversed the trial court based on its holding that a

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[3] Id. (emphasis added.)

[4] Larson asserts that the panel did not err by making an independent factual determination based on its painstaking review of the trial court record. Opposition at 25, n.16. Larson is wrong: it is error for a Court of Appeals to make such an inquiry. See, e.g., Pullman-Standard v. Saint, 456 U.S. 273 (1982) (Court of Appeals' independent review of record, and subsequent substitution of its factual finding for District Court's, was error).

single shareholder can bring a derivative suit under Rule 23.1. This ground alone, asserts Larson, was "an adequate basis for reversing the district court's judgment."[5] Thus, concludes Larson, "the Court of Appeals reached the correct result on sound reasoning and there is no reason for this Court to intervene."[6]

Larson's interpretation of the Court of Appeals' decision, however, is simply wrong. There was no conflict between the trial court and the panel on the "single shareholder issue." As the Court of Appeals noted, "the district court acknowledged [that a single shareholder may bring a derivative suit] in its September 8 order."[7] Thus, there was no error of law for the Court of Appeals to correct. In fact, the panel agreed that, if Larson were seeking to rescind the ESOP, there was "a strong argument that [Larson] could not qualify as an

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[5] Opposition at 12-16.

[6] Opposition at 16.

[7] Appendix I at A-24-25. The District Court's September 8 Order is reprinted as Appendix III.

adequate representative because he was 'economically antagonistic' toward the corporation and the other shareholders."[8/]

Contrary to Larson's suggestion, the disagreement between the Court of Appeals and the District Court was over facts, not law. The abuse of discretion standard of review requires that the Court of Appeal accept the District Court's findings of fact if there is any evidence on which it rationally could have made that decision.[9/] Here, however, the Court of Appeals ignored the abuse of discretion standard by conducting an independent review of the facts to determine that Larson was an adequate representative, despite the abundant evidence in the record supporting the trial court's findings.[10/] It is the Court of

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[8/] Appendix I at A-7.

[9/] See, e.g., Petition of Hill, 775 F.2d 1037, 1040 (9th Cir. 1985); see also Round Table's Petition at 30-35.

[10/] Appendix I at A-21. Those facts were Larson's desire to rescind the ESOP, his lack of support from minority shareholders and his personal interest in securing a higher price for his shares.

Appeals' incorrect and inappropriate independent inquiry into the trial court's factual determinations that provide the basis for Round Table's Petition.

Only a single paragraph buried on pages 21 and 22 of Larson's Opposition addresses the central issue.[11] In that paragraph, Larson merely summarizes the evidence listed by the Court of Appeals' in its discussion and asserts that the panel "could properly conclude" that both Larson's and his trial counsel's admissions that they were seeking rescission of the ESOP were "irrelevant because rescission had never been properly sought in the first place."[12] As discussed at length in Round Table's Petition, the Court of Appeals' decision was both demonstrably wrong[13] and an abuse of discretion.[14]

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[11] Incredibly, despite the panel's statement that its decision "essentially turn[ed] on whether, as found by the trial court, [Larson] sought to rescind" the ESOP, only one paragraph of Larson's 26 page brief discusses this issue.

[12] Opposition at 22.

[13] Petition at 21-27.

[14] Petition at 30-36.

Larson's summary assertion that the District Court's conclusion was "clearly erroneous" is meritless.

The inability (or unwillingness) of Larson to respond to the issues presented in Round Table's Petition without grossly distorting the Court of Appeals' decision illustrates the need for plenary review. Although virtually ignored in Larson's Opposition, this case turns on a central factual issue: whether Larson sought to rescind the ESOP. The District Court found that he did. In reversing this factual finding, the Court of Appeals not only impermissibly substituted its discretion for the District Court's, but also made an obvious and dispositive error. These are the issues properly raised in Round

Table's Petition. For the reasons expressed in the Petition, certiorari should be granted.

DATED: November 30, 1990

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